ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

HEARINGS
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
NINETY-SEVENTH CONGRESS
SECOND SESSION

FEBRUARY 23, 24; MARCH 9, 10, 11, 12, 16, 17, 18 AND 19, 1982

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ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

THURSDAY, MARCH 18, 1982

U.S. SENATE,
SENATE FINANCE COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 9:03 a.m., in room 2221, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Packwood, Chafee, Symms, Byrd, Bentsen, Matsunaga, Boren, Bradley, and Mitchell.

The CHAIRMAN. We will continue with the hearings on the administration's proposals and other proposals that are now under consideration.

I think we have about 18 or 20 witnesses this morning. I would suggest to the witnesses, as I have in the past, that I hope that they will summarize their statements because the entire text will be placed in the record. That may give us some time for questions. I am not certain how many members will be here this morning; there are other committee meetings in progress.

Our first witness will be Mr. Ray Dennison, director, department of legislation, AFL-CIO.

STATEMENT OF RAY DENNISON, DIRECTOR, DEPARTMENT OF LEGISLATION, AFL-CIO, WASHINGTON, D.C.

Mr. DENNISON. Good morning, Mr. Chairman.

I am accompanied this morning by Dr. Rudolph Oswald, director of our department of economic research. And I will summarize my statement and try to keep well within the time limit.

The AFL-CIO appreciates this opportunity to present our views on tax proposals of the Reagan administration budget.

The 1981 tax legislation showered huge tax cuts on the wealthy, rewarded the well-to-do, and gave a relative pittance to the rest of America. The AFL-CIO is here today to offer a proposal which includes retaining the full tax cut for all who earn $40,000 per year or less and provides a $700 per year tax cut to those who earn more than that amount. This revision and other AFL-CIO proposals would recapture sufficient revenues to restore worker assistance programs that have been weakened or destroyed, and take a large stride toward restoring tax equity.

The AFL-CIO proposal would raise revenues equitably, thus providing funds for programs the Reagan administration would cut further, as well as providing funds for programs to put jobless

Americans to work. A means to cut the deficit is also proposed by the AFL-CIO through the closing of the most egregious tax loopholes. Further, if defense needs require additional funding, the AFL-CIO proposes that these added funds be raised by means of a progressive surtax.

The 1982 administration tax proposals add up to a melange of gimmicks and token devices to make the deficit appear smaller and diffuse the rapidly growing chorus of criticism over last year's tax law.

The AFL-CIO's alternative tax program would correct the worst inequities in last year's tax legislation and provide revenues necessary to meet national priorities, protect workers and the poor, and fund programs to provide jobs, incomes and purchasing power to lift the economy out of the recession.

The specific tax measures proposed by the AFL-CIO are:

Cap the 1982 and 1983 tax cuts at $700 per family. This cap would have little or no effect on families with incomes of $40,000 or under.

Repeal the leasing of tax credits by corporations.

Repeal the loopholes in the oil windfall profits tax.

Modify the estate and gift tax provisions.

Repeal the indexation provisions.

In the matter of the defense budget, if Congress determines that higher levels of defense spending in fiscal 1983 are required, this increase should be fully financed by a progressive surtax on income. At least one-third of this tax should be provided by an inescapable levy on gross corporate earnings. In this way, defense needs can be met without adding to the Federal deficit or cutting food stamps, unemployment benefits, job and training programs, mass transit, or other already battered social programs.

We also urge, in closing the tax loopholes, the repeal of the deferral privilege, elimination of the Domestic International Sales Corporation, ending of the depletion allowance, reducing the investment tax credit, limiting the lower tax rates that apply to the first $100,000 of corporate income to small corporations, the phasing out of the capital gains preferences.

The rest of my statement, Mr. Chairman, we ask be placed in the record.

We are convinced that a 180 degree change in direction is essential to prevent the worsening of the recession and to begin the job of revitalizing the Nation and adding the critically needed element of fair play to national economic policy.

The AFL-CIO's support for fair tax policies reflects our membership's willingness to pay their fair share of taxes for meeting our Nation's needs. We ask Congress to consider and enact the AFL-CIO's tax program.

Thank you, Mr. Chairman.

The **Chairman**. Senator Packwood.

Senator **Packwood**. No questions.

Mr. **Dennison**. Mr. Chairman, if I may, I would like to ask that our testimony also include the AFL-CIO executive council's statement, "An Alternative to Reaganomics."

The **Chairman**. That will be made a part of the record, Mr. Dennison.

[The prepared statement follows:]

STATEMENT BY RAY DENISON, DIRECTOR
DEPARTMENT OF LEGISLATION
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS
BEFORE THE SENATE FINANCE COMMITTEE ON THE REAGAN ADMINISTRATION'S TAX PROPOSALS

March 18, 1982

The AFL-CIO appreciates this opportunity to present our views on tax proposals of the Reagan Administration Budget.

The Reagan Administration tax legislation showered huge tax cuts on the wealthy, rewarded well-to-do companies and gave a relative pittance to the rest of America. The AFL-CIO is here today to offer a proposal which includes retaining the full tax cut for all who earn $40,000 per year or less and provides a $700 per year tax cut to those who earn more than that amount. This revision and other AFL-CIO proposals would recapture sufficient revenues to restore worker-assistance programs that have been weakened or destroyed -- and take a large stride toward restoring tax equity.

The AFL-CIO proposal would raise revenues equitably, thus providing funds for programs the Regan Administration would cut further, as well as providing funds for programs to put jobless Americans to work. A means to cut the deficit is also proposed by the AFL-CIO through the closing of the most egregious tax loopholes. Further, if defense needs are to require additional funding, the AFL-CIO proposes that these added funds be raised by means of a progressive surtax.

The Administration tax proposals add up to a melange of gimmicks and token devices to make the deficit appear smaller and defuse the rapidly growing chorus of criticism over last year's tax bill.

The AFL-CIO's alternative tax program would correct the worst inequities in last year's tax legislation and provide revenues necessary to meet national priorities, protect workers and the poor and fund programs to provide jobs, incomes and purchasing power to lift the economy out of recession.

The specific tax measures proposed by the AFL-CIO are:

Cap the 1982 and 1983 tax cuts at $700 per family.

This measure would add a substantial element of equity to the 1982 and 1983 individual income tax cut by trimming back on some of the huge cuts that would otherwise flow to those at the upper ends of the income scale. The cap would have little or no effect on most families with incomes of $40,000 or under. Above that amount, most taxpayers would be denied a portion of the reduction but their taxes in 1982 would still be $700 below pre-1981 levels and they would still receive a cut in 1983.

The attached table illustrates the effects of the proposals and shows, for example, that in 1982 a $40,000 family of four retains its full tax cut and at $45,000 only $93 out of the $793 reduction is foregone. In the higher brackets, of course, the proposals have a substantial effect -- the $6,223 cut scheduled for 1983 for a taxpayer with a $100,000 salary and a $50,000 capital gain is reduced to $1,400 -- an amount that is still almost four times larger than the reduction for a $20,000 wage earning family of four.

We estimate that this proposal will recoup about $20 billion of the revenue lost by the 1981 tax cuts.

Repeal the leasing of tax credits by corporations.

The so-called "safe harbor leasing" rules have widered the definition of a tax qualified lease in a fashion which permits corporations that owe no taxes to, in effect, receive a tax cut anyway and substantially enlarges the tax benefits available to large and profitable businesses.

The revenue loss due to this provision will be nearly $7 billion by the end of FY 1983 and by 1986 its cost will be $8.5 billion annually.

Repeal the loopholes in the Oil Windfall Profits Tax.

The 1981 tax law provided a series of tax bonanzas to oil royalty owners and producers of "new" oil. The FY 1982-1983 cost of these provisions is respectively, $1.3 and $1.7 billion, rising to $3.6 billion in 1986.

Modify the estate and gift tax provisions.

The 1981 Act through a variety of increases in credits, exemptions, rate cuts and valuation devices has effectively destroyed the estate and gift tax. Only the estates of the very wealthy -- an estimated 3% -- paid federal estate and gift taxes and as a result the heirs of these estates are the sole beneficiaries of this provision. The AFL-CIO recommends that the provision be modified to raise at least $1 billion in additional revenue.

The AFL-CIO also calls for repeal of the indexation provisions scheduled to go into effect in 1985. That provision would amount to a permanent and continuing erosion of the tax base and would substantially damage the stabilizing impact of the tax structure during periods of economic overheating.

A word about taxes and the defense budget. We remain convinced that the American economy can sustain a strong national defense without short-changing vital social programs that reflect the values of our society.

We do feel that the Administration's policies have set up a situation where a destructive guns-versus-butter debate has been revived and the Administration has clearly opted for the latter. We feel that the defense budget should be subjected to the same close scrutiny that social programs have always undergone and if Congress determines that higher levels of defense spending in fiscal 1983 are required, this increase should be fully financed by a progressive surtax on income. At least one-third of this tax should be provided by an inescapable levy on gross corporate earnings. In this way, defense needs can be met without adding to the federal deficit or cutting food stamps, unemployment benefits, job and training programs, mass transit, or other already battered social programs.

If the Congress wishes to reduce the deficit, the AFL-CIO suggests a list of specific loopholes which if closed or trimmed could generate substantially more revenue and represent a beginning step toward tax justice.

Specifically:

*Change the foreign tax credit to a deduction. The foreign tax credit provision allows U.S. corporations to credit foreign income taxes on a dollar-for-dollar basis against their U.S. tax liability. We feel income taxes paid by U.S. corporations to foreign government should be treated as costs of doing business and deducted from income just like the taxes paid to state and local governments. At least $10 billion of annual revenue could be generated through such action.

*Repeal the deferral privilege which allows multinational corporations to defer U.S. income tax payments on the earnings of their foreign subsidiaries until such time as the firm decides to bring the profits home. This loophole costs over $500 million per year and is a key factor in encouraging U.S. firms to operate overseas.

*Eliminate the Domestic International Sales Corporation (DISC) gimmick which allows corporations to spin off into export subsidiaries in order to defer, perhaps indefinitely, taxes on substantial portions of export profits at a revenue loss of nearly $2 billion per year.

*End the depletion allowance and the immediate expensing of certain drilling costs to generate some $6 billion in revenue.

*Reduce the Investment Tax Credit -- currently the single most costly business tax preference -- to its former 7 percent level. In view of the huge depreciation giveaways enacted last August there is no justification for maintaining this provision. Reducing the credit from 10 percent to 7 percent could raise over $7 billion.

*Limit the lower tax rates that apply to the first $100,000 of corporate income to small corporations. Although this provision is typically justified as a device to help small business most of the benefits flow to the largest and most prosperous corporations, at an annual revenue loss of $7-8 billion.

*Phase out capital gains preferences which put a ceiling of only 20 percent on the tax rate and completely exempts from the income tax such gains when they are passed on at death. This proposal would raise $12 billion.

Mr. Chairman, we recognize that the program we are urging is ambitious. It calls for a complete reversal of the tax policies of the past year and it requires a recognition that a major error was made and requires a will to correct it.

We are convinced that the crazy quilt combination of the Reagan Administration's huge tax cuts, dismantled programs and sky high interest rates is the direct cause of the present deep recession, high and rising levels of joblessness, and the budgetary mess. We are also convinced that the inequities and imbalances of these programs have seriously undermined the capacity of the economy to turn itself around and regain the strength and resiliency necessary to move forward.

The Administration's failed "Economic Recovery Program" promised a "supply-side" outpouring of investment, output, jobs, and public revenue as the result of the 1981 Tax Cut. It promised that 1.4 million more people would be at work by the end of the year, and, the national output would grow by 4.2 percent.

Instead the Reagan Administration has plunged the nation into the worst decline since the Great Depression and the end is nowhere in sight. Since last July, the number of unemployed has increased by 1.8 million; 30% of industrial capacity is idle and factory output is down 8.6%. Construction industry unemployment is above 18%, housing starts are at historic lows and last week, the Commerce

Department reported business spending plans -- despite the $14 billion that will flow in business tax incentives -- is likely to fall by 1% in real terms.

Despite this, the Reagan Administration tells America we should wait. The investment numbers were made retroactive to January 1981, with no positive results thus far in either 1981 or 1982. The capital gains reductions were made effective in June of 1981 with no beneficial effects shown for the economy. While we are asked to wait 9.3 million Americans are jobless, thousands of Americans have had their mortgages foreclosed and business and personal bankruptcies are at a 40-year high.

As for the Administration's tax proposals, if every single one of the 24 income, excise and employment tax provisions, user charges and collection fees were enacted as proposed, $15.9 billion in additional FY 1983 revenue would be collected. This certainly is a respectable amount, but it falls far short of needs and adds up to nothing when measured against the need to restore some equity to the federal tax structure.

The highly publicized corporate minimum income tax, for example, does not even offset the revenue loss of the leasing provisions the excise, employment taxes and user fees only add to inequity.

We believe a major effort must be undertaken to create jobs and reverse the economy's downslide. At the same time interest rates must be lowered and the federal government's dismal fiscal position should not be exacerbated.

Mr. Chairman, in our view, this adds up to a need for a carefully balanced policy of direct targeted programs that can fight recession and cushion its effects, and requires drastic corrective surgery on last year's tax bill.

We are convinced that a 180 degree change in direction is essential to prevent worsening of the recession and to begin the job of revitalizing the nation, and adding the critically needed element of fair play to national economic policy.

The AFL-CIO support for fair tax policies reflects our membership's willingness to pay their fair share of taxes for meeting our nation's needs. We ask Congress to consider and enact the AFL-CIO tax program.

Effect of the AFL-CIO Proposal to
Cap the 1982 and 1983 Individual Tax Cuts at $700

			1982 Tax Reduction			1983 Tax Reduction		
Income		Pre-1981 Law Tax Liability	Current Law	AFL-CIO Proposal	Diff.	Current Law	AFL-CIO Proposal	Diff.
$10,000	(family of 4)	$ 550	$ 74	$ 74	None	$ 111	$ 111	None
	(family of 2)	900	114	114	"	171	171	"
	(single)	1,177	134	134	"	226	226	"
$20,000	(family of 4)	2,013	228	228	None	371	371	None
	(family of 2)	2,457	268	268	"	459	459	"
	(single)	3,115	326	326	"	610	610	"
$30,000	(family of 4)	3,917	405	405	None	744	744	None
	(family of 2)	4,477	465	465	"	844	844	"
	(single)	5,718	566	566	"	1,081	1,081	"
$40,000	(family of 4)	6,312	639	639	None	1,188	1,188	None
	(family of 2)	7,052	719	700	$ 19	1,328	1,328	"
	(single)	8,886	874	700	174	1,653	1,400	$ 253
$45,000	(family of 4)	7,737	793	700	93	1,458	1,400	$ 58
	(family of 2)	8,528	873	700	173	1,606	1,400	206
	(single)	10,673	1,047	700	347	1,980	1,400	580
$50,000	(family of 4)	9 323	947	700	247	1,754	1,400	354
	(family of 2)	10,183	1,027	700	327	1,914	1,400	514
	(single)	12,559	1,239	700	539	2,326	1,400	926
$120,000*		35,578	2,229	700	1,529	5,324	1,400	3,924
$120,000**		36,477	3,128	700	2,428	6,223	1,400	4,823

*Four person family, all income from wages or salary
**Four person family with $100,000 salary income and $50,000 capital gains (of which only 40% or $20 000 is included in income)

Note: All calculations based on usual assumption of personal deductions equal to 23% of income and one wage earner.

Statement by the AFL-CIO Executive Council

on

Health Care

February 18, 1982
Bal Harbour, Fla.

Even before the Reagan Administration took office some 40 million Americans lacked public or private health care coverage. In the last year, the number of persons without protection for health care financing has risen significantly.

In 1981, the Administration recommended, and Congress acted, to take away Medicaid benefits from at least a million poor people -- mostly low-paid working mothers and their children. Others still on Medicaid suffer sharp limitations in covered services. Some states, taking their cue from the Administration, have cut back their Medicaid programs even more drastically than the new federal restrictions require.

Millions of additional workers and their families lose health care coverage as they lose their jobs. Still more face the same plight as unemployment continues to rise.

In addition to massive lack of health care coverage, the country faces ever mounting medical costs, which continue to far outpace the overall cost-of-living index. Health care workers are not to blame. Since 1972 real wages have fallen 5 percent for hospital workers and more than 12 percent for nursing home employees.

In the face of large scale deprivation of needed health care and rapidly escalating medical costs, the Administration has done nothing to control medical cost inflation or assure access to care.

The unemployed and poor who have nowhere else to go turn to public and inner-city hospitals. In cities all over the country, these hospitals face bankruptcy and closure as a result of expanded caseloads and depleted financial resources. Reduced funding for community health centers has deprived poor and elderly patients of their only source of care. The health care program for migrant workers and their families has also been gutted.

Public health service hospitals, which in recent years served not just merchant seamen and their families but also many low-income persons, have been closed. The health planning program, which has focused on rationalizing the health care system, is being rapidly phased out. Likewise being dismantled is the National Health Service Corps which gave young physicians a chance to practice in underserved rural and urban areas. Funding for health maintenance organizations (HMOs), which provide prepaid comprehensive services in the most cost-effective manner, has also been withdrawn. The Administration is cutting funds for the Centers for Disease Control, the principal agency for identifying and controlling the spread of infectious diseases.

To the disastrous health care crisis the nation faces, the Reagan Administration offers only one response -- its so-called "competition" proposal. The Administration would use tax gimmicks to put a ceiling on employer payments for health insurance and thus force labor and management to reduce health care coverage achieved through collective bargaining. Tax rebates would be offered to entice employees to choose the lowest cost plans with the worst health care cost protection. HMOs would be especially hard hit since they could not offer their customary comprehensive coverage at the cut-rate premiums the proposal would mandate. A variant of the proposal, using a medical voucher scheme, would sharply restrict Medicare services for the elderly and severely disabled.

While severely restricting health care protection, the "competition" proposals would do nothing to expand the opportunity for affordable health coverage for millions of unprotected Americans. These proposals would leave doctor fees or hospital charges completely uncontrolled. Also untouched is the alarming trend toward unrestrained and often ineffective use of the most costly technological equipment and procedures in medical care. Insurers would "compete" to cover the healthiest and wealthiest through expensive marketing and advertising campaigns. While placing additional cost burdens on patients, the "competition" scheme would place no cost restraints on doctors, hospitals or insurers.

The AFL-CIO will continue to oppose the enactment of "competition" legislation.

The only way to assure all Americans access to quality health care they can afford is through enactment of universal comprehensive national health insurance. Until that long-sought goal is achieved, genuine health care cost control legislation would be highly desirable. Such a program would require negotiated budgets with full worker and patient protections for hospitals and negotiated fair fee schedules for physicians.

We will fight any further cutbacks in Medicare, Medicaid and other programs which provide health care for the poor, the elderly, the disabled and other disadvantaged Americans. We will strive for legislation maintaining health care protection for workers who lose their jobs. We support enactment of H.R. 5199 which would permit states to restore coverage for the working poor and their families who were deprived of Medicaid when they lost their welfare eligibility.

We will not rely on the legislative route alone. We urge AFL-CIO affiliates through collective bargaining to seek to improve the financing, organization and delivery of health services. By using their bargaining powers as purchasers of health care, unions can provide some cost relief without sacrificing care for their members and their communities. Together with employers and other community leaders, unions can help to develop prepaid group practice plans on a local community level.

An important task is to start now to organize local area coalitions involving labor, management, and other concerned groups in the community to take whatever steps may be effective to help restrain health care costs and improve the quality of and expand access to health care. We, therefore, welcome the statement of six national organizations representing providers, insurers, business and organized labor pledging a determined effort to promote the development of such coalitions. While the agenda and composition of each coalition will be determined locally, one effective measure that should be considered is to seek agreement by the parties represented in the coalition to develop mechanisms for negotiation of hospital budgets and physician fees as a way of restraining medical cost escalation.

We urge our affiliates to recommend to their local unions active participation in these groups.

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NOTE: Factsheet

Overview

The Reagan Administration's war on the poor, the aged, working people and consumers was largely won in the last conservative Congress. Not satisfied with winning a major battle, the Administration has announced its intention of cutting the federal budget for fiscal year 1983 another $35 billion to come primarily out of health and public welfare programs. A major target will be the entitlement programs of Medicare and Medicaid.

The Omnibus Budget Reconciliation Act of 1981 included the following program reductions:

* **Medicare** -- The annual deductible for medical insurance (Part B of Medicare) was increased from $60 to $75. The hospital deductible (Part A) for the first 60 days in the hospital was raised from $204 to $260. For a hospitalization that lasts more than 60 but not more than 90 days, patients will have to pay $65 a day (up from $51) and for the 60 reserve days, they will have to pay $130 instead of the present $102. After 20 days in an extended care facility, a patient will have to pay $7 more for the 21st through the 100th day. These and other Medicare cuts will total $305 million in 1982, $1.8 billion in 1983 and over $2 billion in 1984 -- all out of the pockets of the elderly and severely disabled.

* **Medicaid** -- The President's proposed ceiling on federal Medicaid expenditures was rejected by Congress, but the Reconciliation Act provides for a reduction in the projected costs of the program of 3 percent, 4 percent and 4.5 percent in the next 3 fiscal years thereby achieving a savings of about $3 billion in FY 1983. These slashes will come out of the pockets of the jobless and the poor. The $3 billion cut in federal matching funds will require the states to take legislative or executive action to restrict eligibility benefits and/or provider

reimbursement. So far, 35 states have acted. For example, 14 states have adopted changes reducing the number of eligibles. Four states no longer cover AFDC-UP (aid to families with an unemployed parent) families.

Restrictions in the new law on eligibility for Aid to Families with Dependent Children (AFDC) based on income will mean thousands of patients will lose their welfare payments and eligibility for Medicaid. Working mothers, in particular, have had to quit working to maintain their AFDC and Medicaid benefits which often amount to more than their earnings.

To add insult to injury, the Reagan Administration has proposed relaxing or repealing rules that govern nursing homes, the rights of patients and the qualitifications of staff including a current requirement that nursing homes must not employ people with communicable diseases. These rules were, at least, some protection for nursing home patients in some of the profiteering private nursing homes.

Block Grants

The Administration's budget proposal provided for the consolidation of 25 health programs into just two block grants to the states with minimal federal oversight. The Administration succeeded in obtaining $1.2 billion in cuts. Vigorous advocacy by health organizations, consumer groups and organized labor and the strong leadership of Congressman Henry Waxman (D-CA) saved some of the categorical programs including childhood immunization, tuberculosis and venereal disease control, family planning, primary care research and development and migrant health centers which continue as federal programs. One new categorical grant program was created: the Adolescent Family Life or, as it came to be known, the "teenage chastity bill." The other 19 health grant programs were combined into four block grants with, at least, some federal strings. They are:

- **Maternal and Child Health Block Grant** which includes the old Title V of the Public Health Service Act, maternal and child health and cripple children's services program, and six other programs, the most important of which are supplementary security income for disabled children, lead-based paint poisoning prevention, adolescent pregnancy and genetic disease programs. Funds for these programs were cut from $456 to $347 million, or 24 percent.
- **Preventive Health and Health Services Block Grant** combining eight programs, the most important being: home health, fluoridation, health education, emergency medical services, hypertension and health incentive grants. These programs were axed from $99 to $82 million, or 17 percent.
- **Alcohol, Drug Abuse and Mental Health Block Grant** which continues the old community mental health centers and alcohol and drug abuse services with a budget reduction of 24 percent.
- **Primary Care Block Grant** continues the community health centers as a separate program and gives the states the option of whether to administer the centers themselves or allow the federal government to continue doing so. The program was cut about 15 percent.

Organization of Health Services

- **Health Maintenance Organizations (HMOs)** -- Grants to start new programs were eliminated. Only $20 million was authorized for guaranteed loans for developing plans. The sum could only support five or six new plans to become operational. About 100 developing plans will either have to close their doors, with a waste of federal dollars, or be taken over by private investors as profit making operations.
- **Health Planning** -- The reconciliation bill authorizes the planning program, but only for one year. The Administration's plan to terminate federal support this

year was not adopted, but funding for planning was substantially reduced to $102 million. The deadline for state compliance for certificate of need (CON) has been extended to October 1, 1982. Federal funds for state CON laws have been terminated.

- **Public Health Service Hospitals** -- The PHS hospital system for merchant seamen in existence for over a century has been phased out.

Drugs

Regulations governing the marketing and sale of prescription drugs have been greatly weakened by the Administration. For example, the regulation requiring patient package inserts containing basic, easy-to-understand information on contraindications and possible adverse side effects from taking prescription drugs has not been implemented. The regulations governing the testing of new drugs for saftey and effectiveness have also been weakened.

Proposed New Cuts by Administration

Yet to be acted upon this year are additional proposals to cut the budget another $43 billion. Among these are:

- **Medicare** -- Requiring employers to continue private health insurance for those who continue to work after age 65. Over 65 workers would lose their Medicare coverage. Requiring federal employees to begin paying the Medicare tax of 1.3 percent. Indexing the Part B Medicare premium to the cost-of-living. Instituting co-payments for home health services of 5 percent for the first 100 visits (about $2.40/visit) and 20 percent thereafter. Home health visits are currently free.
- **Medicaid** -- Charging Medicaid patients for a part of the cost of physician and hospital care in the form of co-payments. Allowing states to require that

families of Medicaid patients in nursing homes pay part of the cost of their stay. Reducing federal payments for optional benefits under Medicaid such as eyeglasses, dental care and physical therapy. Limiting federal reimbursement to the states for administrative costs.

These changes would cut expenditures for Medicare and Medicaid by $4.7 billion in FY 1983. See attached chart.

Both the enacted and proposed budget cuts would be totally unnecessary if a universal and comprehensive national health insurance program were enacted in the United States. For example, Canada spent 6.1 percent of its Gross National Product (GNP) on health care in 1965 before it enacted a comprehensive and universal national health insurance program. In that year, the United States spent less than Canada, or 5.9 percent. After national health insurance was enacted in that country, medical care costs rose less rapidly than in the United States. By 1970, Canada was spending 7.1 percent of their GNP for health while the U.S. was up to 7.5 percent. In 1975, Canada was still spending the same, or 7.1 percent, while the U.S. was spending 8.6 percent of its GNP. Since 1975, health care costs have decreased to 7 percent in Canada and have been maintained at the same percentage through 1980. In the United States, health costs have risen from 8.6 percent in 1975 to 9.4 percent of its GNP in 1980. See attached chart.

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PROPOSED REAGAN CUTS FOR FY 1983

The following summarizes the major cuts in the Administration's FY 1983 health budget. The details and final estimates may differ when actual FY 1983 budget is submitted to the Congress.

-- **Medicaid** -- Federal Medicaid payments to the states would be cut by about $2.2 billion in FY 1983. This cut is on top of the $0.9 billion cut already programmed into FY 1983 by the Reconciliation Act that was enacted just six months ago. These cuts would be shifted to hard pressed state and local governments, and to the aged, blind, and disabled poor and dependent children.

-- **Medicare** -- Medicare would be cut by about $2.5 billion in FY 1983. This cut is in addition to the $1 billion cut already programmed into FY 1983 by last year's Reconciliation Act. These costs would be shifted to the elderly and disabled, to health providers, and to state and local governments.

-- **Family Planning** -- This program was funded for $162 million in FY 1981. Last year, after a vigorous debate about including it in a block grant, the Congress retained it as a categorical program, with funding at a reduced level of about $124 million. This year's budget again proposes to repeal and consolidate the program into an unrelated health services block grant.

-- **Maternal and Child Health, and Special Supplemental Food Program for Women, Infants, and Children** -- The FY 1983 budget proposes to combine these programs into a block grant, and to cut authorized funding by about 22 percent -- $300 million less than the FY 1982 funding level, and nearly $600 million less than required to maintain the programs at the FY 1981 service level. The Administration could be expected to request further cuts during the appropriations process.

-- **Nursing Programs** -- The FY 1983 budget proposes to cut these programs to $12.5 million, compared to the FY 1981 level of $80 million, and FY 1982's reduction to $47.3 million. Student loans would be eliminated. Coupled with last year's changes, that would mean that no financial aid would be available to students attending nursing school, despite the nationwide shortage of nurses.

-- **National Health Services Corps Scholarships** -- The FY 1983 budget proposes to cut this program to $11 million, compared to the FY 1981 level of $63 million, and FY 1982's reduction to $36 million. No new scholarships would be provided, eliminating a future source of physicians for medically underserved communities across the nation.

-- **Centers for Disease Control** -- The FY 1983 budget of less than $300 million makes no effort to rectify the serious cuts in the FY 1982 budget. Those cuts are expected to reduce the effectiveness of a number of CDC's programs, such as immunizations and VD control.

-- **National Institutes of Health** -- NIH funding for FY 1983 would be $3,660 million. This represents less than a 3 percent increase over FY 1982, and constitutes a reduction in the real dollars available to NIH after adjustment for inflation.

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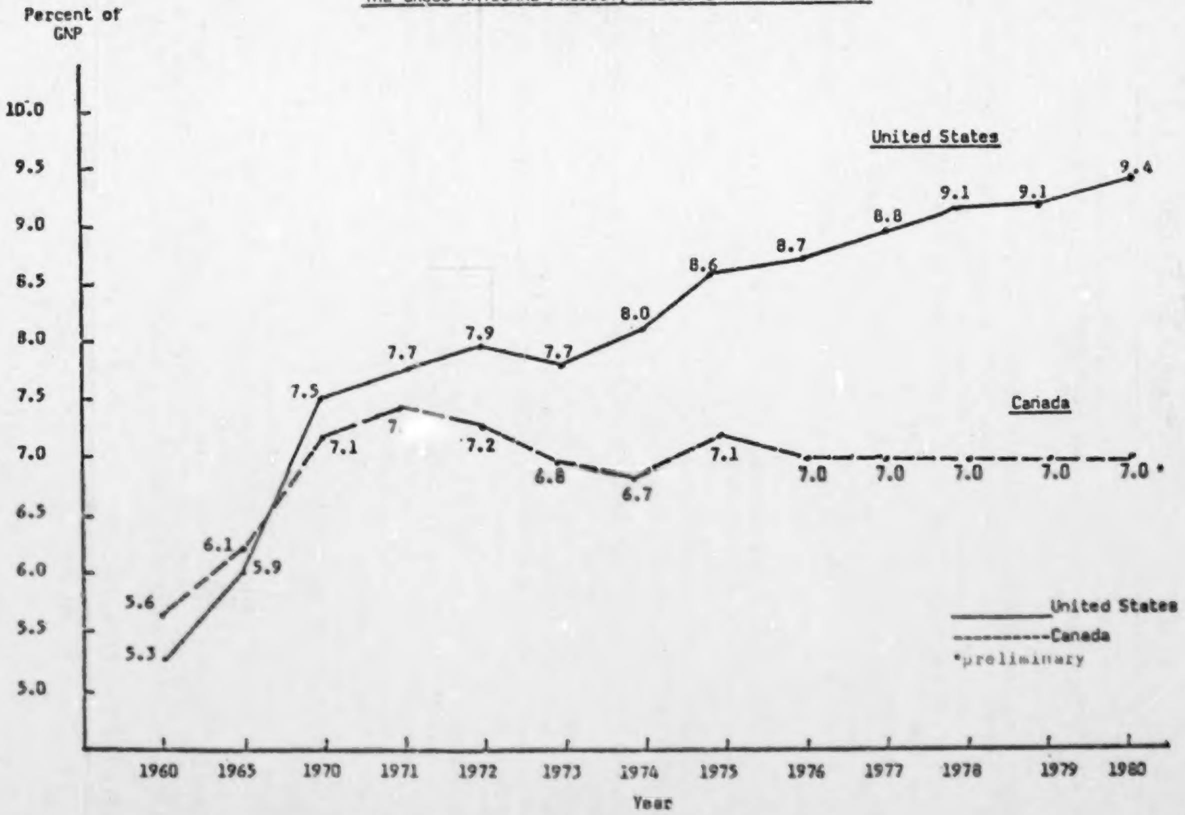
Source: Health Subcommittee, House Energy and Commerce Committee

HEALTH EXPENDITURES AS A PERCENT OF
THE GROSS NATIONAL PRODUCT, UNITED STATES AND CANADA



Source: National Health Expenditures in Canada, Health and Welfare Canada
United States: Department of Health and Human Services

Statement by the AFL-CIO Executive Council

on

Unemployment Insurance and the Employment Service

February 19, 1982
Bal Harbour, Fla.

Millions of jobless workers in the current recession will be deprived of adequate unemployment compensation as a result of ill-considered and harsh restrictions initiated by the Administration and imposed by Congress in the name of a balanced budget.

With unemployment levels higher than any in the postwar period, an effective and sound unemployment insurance system must be the first line of defense against the spread of poverty and worsening recession.

EXTENDED BENEFITS

Harsh provisions imposed by Congress have forced states to slash existing unemployment insurance protections, particularly for the long-term unemployed. The extended benefit program has been drastically eroded as a result of Congressional action in 1980 and 1981. The national trigger has been eliminated, and extended benefit claimants are no longer included in the calculation of the state triggers. Long-term jobless workers receiving extended benefits can now be compelled to take minimum wage jobs. As the result of two additional restrictions that will take effect on October 1, 1982, extended benefits will be paid in fewer states and 20 weeks of qualifying employment will be required for eligibility.

These negative federal standards will result in economic disaster for workers unemployed as a result of economic downturns over which they have no control and for which they should bear no responsibility.

We therefore urge the Congress to immediately restore the protections of the extended benefit program that have been eliminated and extend the duration of benefits to 65 weeks. Since the recession-induced unemployment is national in scope, these

Recent Cutbacks in the Employment Service/Unemployment Insurance Administrative Budget

Recent funding cuts in the Employment Service/Unemployment Insurance administrative budget have forced states to close local offices and reduce the size of the Employment Service Staff. As a result, recipients of unemployment compensation benefits will be faced with drastically diminished services.

During fiscal year 1981, approximately 400 local Employment Service offices were closed with accompanying layoffs of 5,000 staff as a result of preparations for reduced funding levels in FY 1982. By October 1, 1982, it is estimated that an additional 600 local Employment Service offices will close due to an additional $210 million reduction in FY 1982. It is likely, therefore, that as many as an additional 10,000 Employment Service staff could lose their jobs.

Although the Department of Labor is cutting only the Employment Service's administrative budget, unemployment insurance services will be impacted. In many states, Employment Service and Unemployment Insurance offices are co-located. In those states, Unemployment Insurance offices will also close and consolidate elsewhere in the state. Unemployment compensation recipients, therefore, will be forced to travel long distances in order to obtain Unemployment Insurance Services. In addition, in states where Employment Service staff have bumping rights into Unemployment Insurance jobs, Employment Service staff will replace experienced Unemployment Insurance personnel.

Since it is apparent that the workload generated by increased numbers of unemployed workers cannot be handled by the few offices and personnel remaining, the Congress has passed a supplemental appropriation of $210 million for the Employment Service administrative budget and $133 million for the projected increase in claims processing for unemployment compensation. It is projected that this level of funding would allow the 600 local offices scheduled to close this year to remain open. However, the Administration's reductions in 1981 would not be restored.

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supplementary benefits should be funded by general revenues as the National Commission on Unemployment Compensation has recommended.

CUTBACKS IN THE EMPLOYMENT SERVICE

The United States Employment Service functions as the primary resource for jobless workers in seeking employment and serves a vital role in returning to the workplace jobless workers whose skills and experience would otherwise be wasted. In addition, unemployed workers are required to register with the Employment Service's unemployment insurance division in order to obtain unemployment compensation benefits. The AFL-CIO reaffirms its support of the public employment service system.

Recent funding cuts in the administrative budget for the Employment Service drastically diminish necessary services for the unemployed. Jobless workers are being deprived of their primary, and in most cases, only resource for obtaining employment at the very time it is most needed.

Because of the high rates of unemployment, Congress has been compelled to pass a supplemental appropriation to restore partial funding of the Employment Service. Unfortunately, this level of funding will be less than in 1980.

We, therefore, urge Congress to restore the Employment Service administrative budget, at the very least, to the level at which it was in 1980.

FINANCING

The AFL-CIO has long advocated improvements in the financing of the unemployment compensation system. These recommendations have been neglected in favor of piecemeal approaches and cutbacks in unemployment insurance protections.

With the extremely high rate of unemployment, the federal funds allocated to the states for unemployment insurance payments are insufficient to cover unemployment compensation benefit claims. As a result, Congress has had to pass an emergency supplemental appropriation of $1.9 billion needed to cover projected benefit claims. With increasing rates of unemployment this additional funding may not be adequate.

The AFL-CIO, therefore, urges immediate steps to restore financial solvency to the system. Because periods of recession-induced unemployment endanger the solvency of state UI funds, the National Commission on Unemployment Compensation recommended a reinsurance mechanism to insure that financing of the system is adequate during periods of escalating costs. We urge Congress to institute such a plan to assure a sound financial basis for the unemployment insurance system.

Since 1968 the unemployment insurance trust funds have been included in the unified federal budget even though the unemployment insurance system is basically financed and administered by the states. As a result, the Administration and Congress have initiated cost-cutting proposals in unemployment insurance program areas simply for budget-reducing purposes. To reduce the likelihood of further such cutbacks in the unemployment compensation program, we urge Congress to enact legislation that would exclude the unemployment insurance trust funds from the unified federal budget.

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Statement by the AFL-CIO Executive Council
on
Social Security

February 19, 1982
Bal Harbour, Fla.

The economic security of most Americans, including millions of AFL-CIO members and their families, depends on social security. They rely on it to safeguard themselves and their families against economic catastrophe when earnings stop because of old age, disability or death. That economic security is now in jeopardy because the Reagan Administration has proposed further cutbacks in addition to those enacted at its insistence last year.

The recent defeat of drastic proposals for further slashes in social security could be only a temporary victory unless Administration efforts to achieve these cuts by other means are thwarted. At the request of the President, a 15-member National Commission on Social Security Reform has been appointed, including AFL-CIO President Lane Kirkland. Five members were appointed by the President and five each by the Republican and Democratic Congressional leadership. Thus, the Commission has a membership likely to assure a majority sympathetic to the Administration's viewpoint.

Moreover, shortly after appointment of the Commission, Social Security Commissioner John A. Svahn said the Administration would reject proposals for adequate financing even if the Commission recommended them. Thus, it would appear that the Administration will support only Commission recommendations which cut benefits.

The Administration has already achieved a number of major cuts in the social security program -- largely through the budget reconciliation process. These include phasing out benefits for dependent children in college or post-secondary schools, eliminating minimum benefits for new applicants and burial benefits for some and levying social security taxation on sick pay. At the same time, the Administration has initiated a massive effort to eliminate up to 20 percent of disability beneficiaries from the rolls through the regulatory process. In the fiscal 1983 budget the President has recommended major cuts in Medicare -- a basic part of the overall social security program. He made this recommendation in spite of his promise not to call for further social security cuts pending the report of the National Commission.

Administration efforts to gut the program continue in spite of expressions of public opposition. Numerous polls have shown overwhelming opposition to cuts and even a preference for additional financial burdens when the alternative would be a reduction in benefits. The most recent example of public feeling on the issue was the emphatic rejection of the Administration proposals for cuts by the delegates to the White House Conference on Aging.

The AFL-CIO supports all efforts to deal with social security problems truly aimed at improving the financial stability of the system and safeguarding its basic protections. We oppose all efforts to make unwarranted cuts disguised as a rescue operation based on exaggerated funding problems. The program faces some manageable financial problems, but these should not be used as an excuse to break faith with those depending on social security now or in the future. We reaffirm our recommendations for removing social security from the Unified Budget and for partial financing of the system from general revenues. Both steps will strengthen the financial status of social security.

We will fight any further cuts in Medicare. We will also do everything possible to thwart the Administration's denial of benefits to the disabled.

The AFL-CIO pledges to defend the social security program and the fundamental protections it provides for American workers, active and retired, and to play a constructive role in placing the system on a sound financial basis.

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The **Chairman**. I note that you advocate a number of changes; in fact, changing nearly everything we did last year. [Laughter.]

Mr. **Dennison**. Almost, but not quite.

The **Chairman**. What would you leave?

Mr. **Dennison**. If memory serves me, we did leave the depreciation provisions. We did not go to that part of it. But we did feel that with the depreciation provisions in there, there would then be a logical reason to reduce the investment tax credit.

The **Chairman**. And you don't favor indexing of individual tax rates, right?

Mr. **Dennison**. No, sir; we do not.

The **Chairman**. Does that mean that you believe that when we have inflation that workers who get a COLA adjustment ought to be moved into higher tax brackets?

Mr. **Dennison**. Well, our feeling is that workers, through their collective bargaining agents, and we believe that most workers should have collective bargaining agents, do receive adjustments through the collective bargaining changes in their contracts and adjustments of that nature.

Our fear of indexation goes to the experiences in other countries where indexation across the board has proved to be catastrophic—Israel, Brazil.

The **Chairman**. I don't want to do it now, but I would really like to visit with you about indexing. It seems to me that was something that working men and women would, as I find in my State, understand and support as an effort to protect their real earning power. I know some are opposed to indexing because it takes away the windfall the Congress picks up if we have inflation, which means that we either have to raise taxes or reduce spending. That's another thing about indexing, it puts the pressure on Congress either to have the courage to increase taxes or the courage to reduce spending if we take away the windfall from inflation.

I raised that with Mr. Kirkland, too, when he was there. I put him down as "undecided," and I think he is.

Dr. **Oswald**. If I may, in terms of economic policy, though: During an inflation you do want to have a drag on the rate at which people have money to spend, and you do want to pull money out. And during a recession, you want to have Federal policy put money into the economy and to act counterproductive so that you can have the ability to either provide tax cuts or increase spending programs during a recession and to hold the economy back during inflationary periods.

If you put it on a straight indexing provision, you remove that element of economic policy from the fiscal operation of Government, and we feel that that automatic operation really removes an important tool of Government in inflationary and recessionary policy actions.

The **Chairman**. I appreciate that; but, again, I would seriously like to discuss it further.

Would you support an oil import fee?

Mr. **Dennison**. The AFL-CIO position is to support the creation of a national oil-import corporation and provide that all importation of oil pass through this Government-created entity and then be offered out for bids into the private sector. We feel that would be the best way to gain control over oil energies, but we do not support an oil import fee per se.

The CHAIRMAN. Well, would you oppose it?

Mr. DENNISON. We have in the past; yes.

The CHAIRMAN. Senator Byrd, do you have a question?

Senator BYRD. No.

The CHAIRMAN. We are not trying to move that quickly. Well, we appreciate very much your testimony, and your statements will be made a part of the record. The record will indicate your strong support for accelerated depreciation. [Laughter.]

Mr. DENNISON. I don't think I would quite put it that way. Let me say we'll tolerate it.

The CHAIRMAN. Thank you.

Bob Froehlke, Richard Minck, and Bill Grant.

Let's see, Bob, are you giving the statement?

Mr. FROEHLKE. I am giving the statement; yes.

The CHAIRMAN. The others are support?

Mr. FROEHLKE. I need a lot of help.

The CHAIRMAN. So do we.

STATEMENT OF ROBERT F. FROEHLKE, PRESIDENT, AMERICAN COUNCIL OF LIFE INSURANCE, WASHINGTON, D.C.

Mr. FROEHLKE. Good morning.

I am Bob Froehlke. I am the president of the American Council of Life Insurance; and Bill Grant, on my immediate right, is chairman and chief executive officer of the Business Men's Assurance Co. of Kansas City; and Dick Minck is executive vice president of the American Council of Life Insurance.

I would ask that my complete statement be made a part of the record, and I will very briefly summarize.

The American Council of Life Insurance is made up of 524 companies. We write 96 percent of all the life insurance in force, have 97 percent of all the life assets and 99 percent of all of the pension assets.

We are taxed under legislation enacted in 1959. Subsequent to that, during the 1960's, this legislation worked reasonably well. With the advent of inflation, flaws were revealed. We have come to the conclusion, as has almost anyone else that has looked at this legislation, that the act must be revised. Somewhat reluctantly, we have also come to the conclusion that practical politics dictate that we do not have the time in this session of Congress to revise the entire act. Therefore, the American Council of Life Insurance has developed what we call a stopgap proposal.

There are two primary purposes to this proposal:

1. To increase the revenue for the Government during the stopgap period.
2. To allow Congress, the administration, and hopefully the American Council of Life Insurance, working together, the time to be able to revise that 1959 act.

In that 2-year period we offer and plead that we be allowed to work with the Congress and with the administration in coming up with an act that will overcome those flaws in the 1959 act.

And I am happy to report to you, gentlemen, that the American Council of Life Insurance is united—the stock companies, the mutuals, the large, the small—we are united on this stopgap proposal.

My statement gives the details of the stopgap. I will just briefly comment.

You are well aware that the Secretary of the Treasury proposed that section 820 of the code, dealing with elections that can be used with modified coinsurance, be done away with. And he called for an increase in revenues of nearly $2 billion per year.

Our stopgap proposal would increase revenues by $1 billion per calendar year 1982.

We recognize that section 820 needs to be changed, but we do tell you that there is much more wrong with that 1959 law than section 820, and we strongly urge that you not just look at section 820 but look at all of the provisions we recommend in our stopgap proposal. The stopgap is, nevertheless, a relatively simple proposal.

It is very difficult for an industry to prove or disprove that it is being taxed too much or too little. And I believe, in order to make that case, you have to go to a few statistics.

Since between 1960 and 1978 the taxes on life insurance companies increased six times, during that same period life insurance—gain from operation of life insurance companies—increased four times. All other corporations grew three times—their taxes grew three times contrasted to the life insurance companies' six times and their increase in earnings after taxes was 4½ times compared to the life insurance companies' 4 times. All of our permanent life premiums and reserves only went up 2½ times, and our nonpension assets went up 2½ times.

In conclusion, we do look forward to working with you. We want to provide sufficient funds for the Government; we want to have a law that is fair to the life insurance industry; we want to keep the life insurance industry competitive within our industry as well as with other businesses in the financial services area. We want to keep the price of life insurance at a low level for the vast majority of our policyholders who are of modest means. And, finally, we want to continue to provide the long-term financing for America's business.

I thank you very much.

[The prepared statement follows:]

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE ON A "STOPGAP" PROPOSAL TO REVISE THE LIFE INSURANCE COMPANY INCOME TAX ACT OF 1959

Hearings of the Senate Finance Committee

March 18, 1982

My name is Robert F. Froehlke, and I am the President of the American Council of Life Insurance ("ACLI"). I am pleased to be before the Senate Finance Committee this morning to respond to the Treasury proposal to change the tax treatment of life insurance companies using modified coinsurance arrangements, to discuss the problems of the current tax law which have been reduced by the use of such arrangements, and to present the ACLI's proposal for interim federal income tax legislation for the life insurance business. The ACLI represents 524 life insurance companies, which account for 96% of the life insurance in force in the United States, 99% of the reserves for insured pension plans and 97% of the assets of all life insurance companies in the United States.

Earlier this year the Secretary of the Treasury appeared before the Senate Finance Committee with a proposal to change Section 820 of the Internal Revenue Code in such a way as to eliminate the tax consequences that flow under the current law from the use of modified coinsurance arrangements. The proposal was to be effective January 1, 1982 and would increase the taxes payable by the life insurance business by nearly $2 billion per year. We urge that such legislation not be enacted except as part of a package with some other needed changes in the law.

Otherwise life insurance companies would be put back in the position they were in during the last half of the 1970's. They would be faced with a tax that had grown and was continuing to grow far faster than their operating gains. They would be unable to reduce the prices charged for individual life insurance to reflect fully the high interest rates currently being earned. The taxes would result in higher prices for policyholders. There would eventually be less funds accumulated through the sale of individual life insurance policies that could be used as long term capital.

The reason that life insurance companies were experiencing severe tax problems at the end of the 1970's is that life insurance companies are taxed under special provisions of the tax code that have been unchanged since 1959. But in recent years, soaring inflation and historically high interest rates have revealed serious flaws in the 1959 Act, with the following results: (1) the share of corporate income taxes paid by life companies almost doubled from 1959 to 1978; which led to (2) widespread use of an election under Section 820 that reduced the taxes payable by many companies; and (3) a unified industry effort to develop proposals to revise the 1959 Act.

Over a period of several years we had developed rather extensive proposals for changes we felt to be needed in the 1959 Act. During the latter part of 1981 we discussed our proposals with members of your Committee, members of the House Committee on Ways and Means and members of the staffs of the tax writing committees and of the Treasury. As a result of those discussions, we concluded that it was not likely that Congress would have time to complete a thorough review of the 1959 Act during 1982. We also concluded that Treasury would find the level of taxes payable by life insurance companies unacceptably low if nothing were to be done about Section 820. Therefore, we have developed an interim, stopgap, proposal to provide some degree of tax relief for the industry, while still producing levels of revenue substantially above those currently being paid. The proposal achieves those goals by correcting a number of the obvious breakdowns in the 1959 Act while maintaining its basic structure. During the two-year period covered by the stopgap (tax years 1982 and 1983) we hope to work with you and your aides and with Treasury Department staff to help you to develop a more permanent solution to the critical tax problems of the life industry.

The stopgap proposal incorporates the following two major features:

(1) Changes to Section 809(f) of the Internal Revenue Code which currently severely limits the extent to which mutual life insurance companies may deduct the dividends they pay to their policyholders and also the extent to which stock life insurance companies may deduct dividends they pay to their policyholders and other deductions available with respect to certain nonparticipating contracts -- contracts which don't provide for dividends. These changes would set minimum levels of deductions that would be

permitted even if they resulted in reducing gains from operations below the amount of taxable investment income less $250,000. Thus, companies would not lose 100 percent of such deductions as they do under current law.

(2) A change in the reserve adjustment formula used to calculate taxable investment income under the current law. The formula in the current law is an approximation that grows progressively worse as the spread between current earnings rates and the interest rates used in reserve calculations increases. The result of the error is to overstate taxable investment income dramatically at the levels of interest rates currently being earned and to drastically reduce the extent to which companies may take the deductions limited by Section 809(f).

We would also propose some procedural provisions to help reach these results for companies in different tax situations. These would include some grandfathering provisions and provisions dealing with methods of consolidating income tax returns for two or more life insurance companies. Our proposed changes would permit life insurance companies to reflect current high interest rates in price reductions and to be able to deduct at least 80 percent of the dividends they actually pay to their policyholders.

BACKGROUND

The Current Problem

The federal law taxing life insurance companies (the 1959 Act) does not work responsibly in an inflationary environment. A comparison of life insurance company federal income taxes to other economic measures of growth of the life insurance business and to the taxes and economic growth for all other corporations clearly illustrates this point.

For example, from 1960 to 1978 while the federal income taxes of life insurance companies increased 6 times, their gain from operations after taxes increased only 4 times. During the same period, permanent life insurance premiums and reserves increased only 2½ times, permanent life insurance in force increased 3½ times and non-pension assets increased only 2½ times.

In contrast, during this same time span the federal income taxes of all corporations grew 3 times while the income of these corporations after taxes grew 4½ times, gross national product grew 4½ times and personal income grew 4½ times.

What these figures illustrate is that, over this period:

--the life insurance business bore an ever-increasing share of the general corporate tax burden; from 2.4% in 1958 (the first year for which the 1959 Act was generally in effect) to 4.2% in 1978, a 75% increase;

--the taxes on the life insurance business grew faster than its gain from operations; and

--permanent life insurance suffered from a depressed growth rate.

The predicament of permanent life insurance is very significant for our economy. During 1980 life insurance companies added about $9 billion to their reserves for permanent life insurance. This inflow of capital funds would have been about $18 billion in that year if the reserves had merely grown in proportion to GNP.

Moreover, the role of life insurance companies as a source of long-term investment capital is longstanding and major. In 1980, life insurance companies provided 30% of all funds raised by American business through corporate bonds and commercial and industrial mortgages.

Why is the 1959 Act not working? The Act is not working because, in 1959, little attention was paid to the possibility that interest rates would rise to their present inflated levels and to how the law would function in such an inflationary environment. While it is evident that inflation and high interest rates have adverse impacts of varying degrees on all parts of the economy, high interest rates have particular significance in the life insurance tax law, because of the law's heavy reliance on investment income in its basic formula. Under this formula, as the rate of investment return increases due to inflation, a higher and higher percentage of investment earnings become subject to tax whether or not these investment earnings are devoted to price reduction in the form of dividends paid to policyholders.

Specifically, since 1959, the portion of the investment income earned on reserves for permanent life insurance that is taxable has increased 2½ times. The increasingly higher taxes mean that a lower and lower percentage of investment earnings can actually be paid to policyholders as dividends.

Companies writing non-participating contracts, those under which policyholders are not eligible to receive dividends, have developed other methods to reflect current high interest rates in the pricing of their contracts. One method has been through direct reductions of premiums. Companies may charge for some contracts a premium rate of $12 per year per $1000 of insurance which would be adequate if current trends continue. However, they may be unable to guarantee such a rate indefinitely; therefore, they reserve the right to increase the rate in the future but not beyond a ceiling of say $20 per year per thousand. An alternate approach is to guarantee that an interest rate of say 4% per year will be credited to a contract and that excess interest will also be credited as determined by the company in future years in order to set various benefits in the contract. Currently total amounts of interest in the range of 10% or 12% may be credited under these contracts.

Currently such methods of reflecting higher interest rates in prices charged by companies for non-participating contracts apparently are fully deductible. That is, the premium actually charged is included in the income of the company -- not the maximum premium the company has the right to charge. Correspondingly, the insurance company is able to deduct fully any excess interest it credits to policyholders. However, the Internal Revenue Service is currently considering regulations which might change this status. If such regulations are issued, companies might lose these deductions entirely because of the limitations imposed by Section 809(f). Under these circumstances, life insurance companies would be unable to reflect current high interest rates in their policyholders' costs by increasing dividends by increasing benefits through excess interest credits or by reducing premiums.

High interest rates -- and the resulting competition for investment dollars -- has also greatly aggravated flaws in the current tax treatment of other insurance company product lines. Of specific immediate concern is the tax treatment of insurance contracts used to fund plans providing qualified pension benefits.

The Present Law

To appreciate why the 1959 Act is no longer working requires some understanding of its mechanics. A basic feature of the Act is its use of a three phase tax computation. The three phases under that computation are:

-- Phase I, which is a calculation of taxable investment income. As explained below, the primary function of Phase I is to establish a limit on the extent to which certain deductions may be taken in computing the company's tax base.

-- Phase II, which is a calculation of the company's total gain from operations including both investment and underwriting income. This, plus Phase III, represents the company's tax base. In this computation, recognition is given to the need for companies in certain situations to make additional provision for future adverse fluctuations beyond the normal reserve. Specifically, special deductions are provided for non-participating insurance, accident and health and group life insurance. In addition, only one-half of the excess, if any, of gain from operation over taxable investment income (such excess may be thought of as underwriting gain) is taxed currently.

-- Phase III, which is an account to which the special deductions and non-taxed half of underwriting gain is posted. If this amount exceeds specified limits or is used to make a distribution to stockholders, such excess or such distribution (plus taxes thereon) is included in the tax base.

In 1978, taxable investment income as computed under Phase I for the life insurance business was about $6.5 billion. For some companies, an excess of gain from operations (in Phase II) over taxable investment income caused the tax base to be higher than taxable investment income by $100 million in aggregate. For other companies, a lower gain from operations caused the tax base to be lower than taxable investment income by an aggregate $400 million. Phase III distributions added about $5 million to the tax base.

Thus, although the mechanics of the 1959 Act would make it appear that the life insurance company tax base is total income, in fact, the tax is, very largely, levied on investment income -- without regard to profits. As interest rate levels have moved substantially upward over the past 20 years, the level of taxes on the industry has increased much more rapidly than has the industry's "bottom line" (i.e., gain from operations). As developed more fully in the following pages, this increasingly progressive tax arises because of a number of aspects of the 1959 Act;

(1) The mechanics of the Act result in unreasonably limiting the deduction a company can take for: (a) dividends paid to policyholders and (b) other so-called special deductions as defined in IRC section 809(f), particularly the deduction for non-participating contracts;

(2) The operation of the Act often results in a tax on insured pension plans, whereas non-insured plans pay no tax; and

(3) The Act contains a technical flaw which, under current conditions, produces an inaccurate deduction for reserve interest requirements.

Each of these problem areas is addressed in our stopgap proposal as discussed below.

THE ACLI STOPGAP PROPOSAL

Liberalize the Present Limitation on Deductions for Dividends to Policyholders and Other Special Deductions

The tax treatment to be accorded dividends to policyholders was one of the major issues confronted by the framers of the 1959 Act. There was concern that if dividends to policyholders were deductible in full, the tax liabilities of mutual companies could be substantially reduced and revenue targets could not be met.

This problem was resolved in the 1959 Act by allowing deductions for some dividends to policyholders but providing a floor below which dividend deductions would not be allowed. That floor was "taxable investment income," which was to be separately computed, less $250,000. The result is that life insurance companies are permitted deductions for policyholder dividends in determining their taxable gain from operations, but those dividends are not allowed to reduce the tax base below taxable investment income less $250,000. [In any event, policyholder dividends up to at least $250,000 are allowed as a deduction in all cases.]

As a result of the operation of these provisions, "taxable investment income" became the key to determining the extent to which dividends to policyholders and other special deductions are deductible. In turn, taxable investment income is controlled in large measure by the formula used to determine the exclusion from investment income related to life insurance reserves. As will be explained in more detail (pp. 15 to 19 of this statement), Congress grounded this formula in the use by each company of its actual earnings rate to be applied against its own life insurance reserves revalued, according to a complex mathematical adjustment referred to as the "10-for-1" or Menge rule, to that earnings rate.

In the early years following enactment of the 1959 Act, actual earnings rates hovered only slightly above assumed rates, and were relatively stable. Hence only modest adjustments had to be made to life insurance reserves in determining the required interest exclusion and the level of "taxable investment income" produced was low enough to permit the deduction of over 90% of dividends to policyholders and other special deductions. Thus, while life insurance companies paid significant taxes, the formula worked to allow tax recognition of the substantial portion of earnings that had to be credited to reserves or returned to policyholders through dividends.

In recent years, however, inflation and the resulting soaring interest rates have had drastic effects that could not have been foreseen by Congress. A chief result has been a sharp drop in the proportion of investment income excluded from the tax base because of increases in life insurance reserves and a resulting dramatic increase in taxable investment income. Since taxable investment income sets the limit on the deduction of policyholder dividends and other special deductions that may be taken in determining gain from operations, those deductions have been drastically reduced. Effective deductions for policyholder dividends fell from 90% in 1959 to about 60% in 1978. When all special deductions subject to elimination by Section 809(f) are considered, the effective level for 1978 falls to 50%. In essence, the present law limitations which deny tax deductions for increasing portions of policyholder dividends penalize policyholders of companies who pay dividends to reduce the price of insurance because favorable experience has made the premiums charged more than was actually needed.

ACLI Proposal

We would propose three types of changes to Section 809(f) to ensure that companies are allowed to take a reasonable level of deductions during the stopgap period.

a. Qualified Pension Plans

When the 1959 Act was passed, Congress clearly expressed its intent that investment income attributable to insured pension plans should be tax-free. Today, at least part of this income often results in a significant tax. Much of this tax is a result of the limitation on dividend deductions imposed by Section 809(f) of the current law. This provision acts to penalize policyholders of companies that seek to pay out investment income earned on qualified funds through the mechanism of policyholder dividends. This result is clearly contrary to the Congressional intent referred to above.

Our proposal would correct this problem by providing a 100% deduction for dividends and similar distributions attributable to qualified pension plans (whether funded with insurance policies or annuities).

b. Other Insurance and Annuity Contracts

As discussed previously, under the 1959 Act as originally implemented, approximately 90% of all other policyholder dividends were deductible. Today, effective deductions for such dividends are less than 60%. If life insurance policies are to remain attractive, insurance companies must be allowed to reflect better investment performance by price reductions in the form of lower premiums, higher dividends or increased benefits. Their inability to do so because of losses of tax deductions through Section 809(f) has resulted in declining attractiveness of permanent life insurance as a savings vehicle.

Our proposal seeks to correct the problem of the snowballing of lost deductions because of Section 809(f) by assuring a minimum deduction of 80% or 87½% for policyholder dividends and the nonparticipating special deductions. The level of this deduction would depend on whether a company does business in, respectively, a mutual or stock form. The differential between mutual and stock companies reflects the differing ownership nature of these two types of companies and responds to the concept that some part of the dividends received by policyholders of mutual companies is a return on their equity in the company.

c. Small Company Treatment

Under the 1959 Act, all companies receive a full deduction for at least $250,000 of their policyholder dividends and other special deductions. This dollar amount figure has been unchanged in 23 years; our proposal would increase the $250,000 amount to $1 million to take account of the inflation that has occurred in the intervening years. This change would restore the assistance to small companies provided by this deduction to a value equivalent to that of the 1959 provision.

Correct Inaccuracies in the Revaluation of Statutory Reserves by Replacing the Present Approximation Formula with a Geometric Ten-For-One Rule and a 9.5% Valuation Cap

The 1959 Act allows each company an exclusion from its net investment income related to its life insurance reserves. To prevent taxes from varying disproportionately in accordance with reserve assumptions that can vary from company to company, the law provides a uniform procedure to be followed by each company in determining the investment income subject to this inclusion.

First, looking to the actual earnings rate on its assets the company determines its adjusted reserves rate. This rate is simply the lower of the current earnings rate on its assets or the average earnings rate over the past five years.

Next, the company reconstructs its life insurance reserves (which are grounded in interest assumptions limited by state law) to restate in effect those reserves as they would have been if the adjusted reserves rate of the company had been used by it in establishing them. This adjustment generally requires a reduction in life insurance reserves. Finally, the company multiplies its revalued reserves by the adjusted reserves rate and this produces its exclusion from net investment income.

Critical to this three step process is the method to be used for revaluing life insurance reserves to the adjusted reserves rate.

Ideally, this would be accomplished through an exact revaluation. But, as the framers of the 1959 Act understood, an exact revaluation of a company's life insurance reserves to the adjusted reserves rate would entail massive effort and detailed analysis that would not be technically feasible for many companies and that, where feasible, would involve onerous costs. Rejecting exact revaluation as impractical and uneconomic, Congress sought a simpler alternative that would reasonably approximate the result of exact revaluation. It settled on the 10-for-1 rule, an actuarial approximation used for many years by insurance actuaries to reasonably approximate changes in amounts of aggregate reserves due to small changes in valuation interest rates. Under the 10-for-1 rule life insurance reserves are revalued to the adjusted reserves rate by reducing them by 10% for every 1% which the adjusted reserves rate exceeds the assumed rate.

The Senate Finance Committee illustrated the application of this rule with an example of an adjusted reserves rate of 3.75% and reserves of $900,000 established at an assumed rate of 2.5%. Thus, the $900,000 of reserves is reduced to $787,500. The company's exclusion is $787,500 multiplied by 3.75% or $29,531.

Congress viewed the 10-for-1 rule in the context of the interest climate of the late 1950's and accepted it as a reasonably accurate means of approximating the results of exact revaluation so as to restate life insurance reserves "as they would have been it the average earnings rate of the company . . . has been used by the company in establishing these reserves." (S.Rep. 291, 1959-2 CB at 781).

Had Congress foreseen the extraordinary rise in interest rates that has culminated in the interest climate of the 1980's and in the U.S. Treasury paying in excess of 13% on long-term debt, it would likely have selected an approximation rule more sensitive to high interest rates. As a means of approximating the reserve that would be produced by exact revaluation, the 10-for-1 rule works reasonably well so long as the differentials between assumed rates and adjusted reserves rates are small -- as in the Senate Finance Committee example. The rule is flawed, however, in that demonstrable distortions and inaccuracies appear once the differential exceeds a few percentage points and these distortions grow progressively worse as interest rates increase.

While average reserve interest assumptions have increased only slightly over the past twenty years (partly because of state law limitations but more due to large portions of reserves attributable to policies written years ago), actual earnings rates which make up adjusted reserve rates have climbed sharply. With industry adjusted reserve rates now about 8% and increasing, while average assumed rates barely exceed 3%, the 10-for-1 rule is producing serious mathematical distortions and artifically low reserve approximations. With the breakdown of the 10-for-1 rule in the present environment, life insurance companies are losing substantial portions of the reserve interest exclusion intended by Congress and are paying much higher taxes because of artificially inflated taxable investment income that results. This is the source of much of the increase in lost deductions resulting from Section 809(f).

Marginal rates of tax on corporations generally are limited by the corporate tax rate of 46%. This is not so for life insurance. For example, under the operation of the present 10-for-1 rule marginal rates on additional dollars of investment income arising from increased earnings rates have moved past 46%. The marginal tax rate on additional investment income will exceed 46% when a company's average investment earnings rate exceeds 6½% (assuming a 3% assumed rate in computing reserves) and will climb steadily as the average investment earnings rate continues to increase. If the average earnings rate reaches 10%, the marginal tax rate on additional investment income will exceed 73%. This means that higher interest rates will inexorably force up the taxes paid by life insurance companies by nearly 75 cents for each additional dollar of investment income even though the companies actually use those dollars to pay dividends to their policyholders, reduce premiums or increase benefits. The only relief from this prospect would be through continued use of reinsurance contracts, if the law is unchanged or through the adoption in changes in the law to ameliorate the impact of Section 809(f).

ACLI Proposal

The ACLI proposal would substitute for the existing arithmetic 10-for-1 formula a modified formula which may be referred to as a "geometric 10-for-1" rule. It produces, in a simple calculation, a much better approximation to an exact revaluation of reserves at the high earnings rates prevailing. The arithmetic 10-for-1 is replaced by $.9^n$ as the multiplier, in which n is the number (positive or negative) determined by subtracting --

(1) the number 100 times the fraction equal to the average rate of interest assumed by the taxpayer in calculating the reserves, from

(2) the number 100 times the adjusted reserves rate.

Thus, if the average rate of interest assumed is 3%, or .03, and the adjusted reserves rate is .08, then n is 5 (100 times .08, minus 100 times .03).

Under the proposed amendment, the adjusted earnings rate may not exceed .095. Without this limit the approximation to an exact revaluation would become worse. The policy and other contract liability requirements would begin to drop as the adjusted earnings rate rose over .095 with the result that the marginal tax rate on increased investment income would exceed the general corporate rate.

The change from the arithmetic 10-for-1 to the geometric 10-for-1 would apply for taxable years beginning in 1982 or thereafter.

Examples of the application of existing law and of the ACLI proposed revision are shown on the following page.

Examples of 10-for-1 Change

Assume:			
Mean of Reserves	$800,000	$800,000	$800,000
Adjusted Reserves Rate	7.5%	10.0%	3.0%
Average Rate of Interest Assumed	3.5%	3.5%	3.5%
Result Under Existing Law:			
Existing Law Multiple	60%	35%	105%
Adjusted Reserves	$480,000	$280,000	$840,000
Adjusted Reserves Rate	7.5%	10.0%	3.0%
Amount Included in Policyholder and Other Contract Liability Requirements	$36,000	$28,000	$25,200
Results Under Proposal:			
Multiply by	$(.9^4)=.6561$		$(.9^{-.5})=1.0541$
Adjusted Reserves	$524,880		$843,280
Amount Included in Policyholder and Other Contract Liability Requirements	$39,366		$25,298
9.5% Ceiling			
Multiply by .9 to the power (9.5-3.5)		$(.9^6)=.5314$	
Adjusted Reserves		$425,153	
Amount Included in Policyholder and Other Contract Liability Requirements (9.5% of adjusted reserves)		$40,390	

Procedural Matters

As stated previously, we would not oppose the general thrust of a Treasury proposal to end the unintended effects of Section 820 provided that it did not result in companies losing forty or fifty per cent of deductions subject to the limitations of Section 809(f). This could be avoided by enactment of stopgap legislation along the lines we propose. With regard to ModCo arrangements entered into in years prior to 1982, we would strongly urge that the Treasury proposal be expanded to include a grandfathering provision that would remove doubt about the tax treatment given companies using the Section 820 election. We would not want current legislation to affect past years adversely.

Our proposal would also clarify an additional point relating to the tax treatment given companies in years prior to the stopgap period. Our proposal would clarify, for these prior years, that excess interest on all products is fully deductible, and that indeterminate premium products do not give rise to "phantom premiums".

Finally, our proposal would include a provision dealing with the basis on which consolidated tax returns filed by two or more insurance companies would be computed. We have urged Treasury that regulations be issued on the subject, but such regulations have not been released. Absent appropriate regulation, companies in a tax situation in which one company of a group is in a phase II positive tax situation (its gain from operations exceeds it taxable investment income) would be unable to take the level of deductions that would be provided by our proposed amendments to Section 809(f). This result would obtain regardless of which company in the group wrote the policies. This would make it impossible for companies in such groups to compete effectively for such business with other companies who could take the full deductions proposed. For this reason, we would ask for clarifying legislation unless appropriate regulations are developed and issued.

Mr. Chairman, the stopgap proposal I have just described is the culmination of many months of serious efforts and reflects points raised in discussions with both Treasury and Congressional staffs. It is also the result of many difficult compromises which had to be made to balance the interests of our diverse membership and to develop a level of revenues that we hope would be acceptable. Inasmuch as this two-year measure is only temporary, however, pressure would still be maintained to arrive at a long-term solution to the problems of the current life insurance tax law.

The stopgap proposal has been approved by the ACLI's Board of Directors and is supported by both stock and mutual companies. If adopted, it would result in tax revenues from the life insurance business being $1 billion higher in 1982 than if no change were made in the current law, about a 60 per cent increase. Our industry is proceeding on a unified basis and, I believe, in a positive fashion to communicate with your panel and your colleagues in the House of Representatives, as well as with the Treasury, on this important tax policy issue.

I appreciate having this opportunity to outline the concerns of the life insurance business over the manner in which we are taxed and our recommendations for dealing with this situation. I will be pleased to respond to whatever questions you may have.

Revenue Effects of the Proposal

Before 1978, the total taxes on life insurance companies could be predicted simply by estimating investment income which reflected the gradually improving asset base and investment return. This could be done because the tax base was almost entirely investment income.

The approach in the stopgap proposal will decrease this historical predictability of the life insurance tax yield. Most companies will be developing their tax liability from the gain from operations before dividends less 80 or 87.5% of policyholder dividends. This means that special operational results of each year, such as health insurance losses or gains, will affect the tax base, which is normal in other industries. One doesn't say that the formula for taxing banks in "wrong" because the total tax on banks is low in a year when most banks have losses. One evaluates the tax on banks from the experience over several years.

Despite these uncertainties, we have provided revenue estimates for our proposal in Table 1. There are several particular important numbers there.

--$2.7 billion which we think would be collected under our proposal;

--$1.7 billion which would be collected under present law; and

--$4.0 billion which are hypothetical collections under present law without ModCo.

First, some comments on the hypothetical $4.0 billion. The most striking thing about this is that it is significantly below the trend line up to 1978. In 1978, the income tax on life insurance companies was $3.0 billion and increasing about 15% a year, on a path that would have brought it to about $5.5 billion in 1982.

Achieving so large a revenue was out of the question for several reasons.

(1) This heavy tax burden has inhibited the growth of permanent life insurance, which is the kind of business that generates most of the tax base.

In the 1950's and early 1960's, ordinary life insurance reserves were growing at about the same rate as the rest of the economy, that is the GNP. The heavy tax burden that had accumulated on this business by 1978 had held the rate down to about half the GNP and since 1978 most companies see their life reserves growing at an even slower rate, some as low as 3% a year.

(2) When companies are faced by declining growth rates, they look at a number of responses. One response is to find ways to do business that involve less tax penalty.

Under the present law, a higher rate of interest earnings reduces the life insurance reserve deduction. The companies look for investment strategies that involve lower current rates of return in exchange for, say, long-term capital gain. Real estate is one such investment. Under the present law the restrictions on exempt interest and the dividends received credit are much less severe for casualty insurance companies than for life companies, so increasingly life companies write health insurance in a casualty subsidiary.

(3) One of the measures to reduce the tax burden was to engage in reinsurance arrangements so as to avoid lost deductions. This is what ModCo is all about.

Our best judgment as to what has been happening in the life insurance business is that the combination of lower growth and reorientations of business under present law (in ways uncontested by the Treasury) brings the prospective revenue for 1982 operations under present law down from the growth curve number of $5.5 billion (projected from late 1970's) into $4.0 billion. Further, the use of ModCo reduces this to about $1.7 billion.

The Treasury has used the revenue estimate of $1.8 billion as the effect of ModCo on 1982 tax liabilities. This is slightly below our number but "in the ballpark" of about $2.0 billion. The Treasury has not made public its estimates of the absolute tax level under present law with or without ModCo.

A final comment is that the estimate of $4.0 billion as revenue under present law without ModCo is hypothetical. It is not an estimate that Treasury revenues would increase by $2.3 billion if you simply repealed ModCo. If you move in that way you would be further inhibiting the growth of permanent life insurance, and further pushing companies into selecting investments on the basis of tax effects.

The other important number in our table is the estimate of $2.7 billion as the expected revenue under our proposal. As can be seen, most of the change from the hypothetical present law without ModCo comes from the provisions dealing directly with wasted policyholder dividend deductions.

We have provided some hypothetical numbers for 1983 operations.

A final comment is appropriate.

Underlying all these numbers is an important issue for the growth of savings and capital in the U.S. economy. In 1979 the growth of savings through ordinary life insurance reserves was $10 billion (which is only half of what it would be if it only kept up with the growth rate in GNP). This is the growth rate which we said was being pushed even lower by the tax burden on life insurance. It is easy to see that even a mild relief from the tax penalty on life insurance can produce a significant improvement in funds flowing into capital markets. If the difference between $4.0 billion and $2.7 billion were viewed as a benefit for life insurance companies and policyholders, it should be looked at in the context of its potential to turn around this flow of savings.

Revenue Projections Under Stopgap

	(Annual Liability) 1982	 1983
	$ billion	
Present Law With ModCo	1.7	1.8
Present Law Without ModCo	4.0	4.3
Stopgap	2.7	3.0
Revenue Change		
--From Present Law Without ModCo	-1.3	-1.3
--From Present Law With ModCo	1.0	1.2
Components of Revenue Change From Present Law Without ModCo		
Qualified Dividend Deductions	0.07	0.08
80/87.5 Dividend Deduction	1.10	1.10
Liberalized $250,000	0.01	0.01
Geometric Menge	0.10	0.10
Total	$1.3	$1.3
Change in Fiscal Year Receipts From Present Law With ModCo	$0.4	$1.3

The **Chairman**. Senator Packwood.

Senator **Packwood**. No questions.

The **Chairman**. Senator Byrd.

Senator **Byrd**. No.

The **Chairman**. Do either Mr. Grant or Mr. Minck care to comment?

Mr. **Grant**. Mr. Chairman, only to stress the urgency of a balanced tax program. To just single out the MODCO would really impose quite a burden on the life insurance industry, and we do earnestly request that it be considered on all the components we are submitting.

Mr. **Minck**. Mr. Chairman, I have nothing further to add.

The **Chairman**. As I understand, your proposal, according to your figures, would raise about a billion dollars a year. Is that correct?

Mr. **Froehlke**. That is correct.

The **Chairman**. And the administration, according to their figures, is seeking $2 billion a year?

Mr. **Froehlke**. That is correct.

The **Chairman**. So are you suggesting that somewhere between $1 billion and $2 billion we might be able to work something out?

Mr. **Froehlke**. We are suggesting $1 billion, Mr. Chairman.

The **Chairman**. Oh. [Laughter.]

It would be worth the try. [Laughter.]

A billion here and a billion there, as somebody said. [Laughter.]

Well, your proposal contains a safety net deduction for 80 to 87.5 percent of policyholder dividends. Wouldn't such a deduction be a logical preference item for life insurance companies under any corporate minimum tax that might be adopted?

Mr. **Froehlke**. Yes. We are recommending that dividends for mutual companies be at 80 percent; for stock companies, be at 87.5 percent—the dividend deduction.

The **Chairman**. Would you like us to include that in the base for the minimum tax?

Mr. **Minck**. I think, Mr. Chairman, there is one thing about it: The dividends we pay to our policyholders are, in effect, a reduction in price to them. So I am not sure that they are of the same character as some of the other items that are in the minimum tax.

The **Chairman**. Well, it is an area that has been suggested. We haven't reached any conclusion on it. We are still waiting for the first volunteer on the minimum tax. I assume there are some in the panel later. [Laughter.]

Is it accurate to say, as we have been told, that MODCO has benefited primarily a very small number of very large companies?

Mr. **Froehlke**. It has benefited the large mutual companies, but I would say it is inaccurate to say "a very few."

MODCO has benefited most companies that have been writing participating policies.

The **Chairman**. And since your proposal would increase Federal revenues by substantially less than the repeal of MODCO provisions, where would the difference go? Is it going back to these same large companies?

Mr. **Froehlke**. No.

The **Chairman**. If you don't totally repeal MODCO or do as the administration suggests and you come in with other provisions, will those provisions benefit the industry as a whole or a few large companies?

Mr. **Froehlke**. Those provisions would benefit the industry as a whole. That is correct. Frankly, that is one reason why we can say the stop-gap proposal has the united backing of the industry.

The **Chairman**. Well, I appreciate very much your willingness to work with our committee and with Treasury to find some area of agreement. I am not suggesting we have it yet, but it is a breath of fresh air to have somebody indicate that they are willing to make certain changes in tax policy.

I understand, too, that we probably can't revise the entire act at this time. We would like to put all of this in a package and put it on the debt ceiling as it goes through here, hopefully soon, before June 1. We will be working with you.

I understand the legislation that you proposed would be ready for introduction by next week.

Mr. **Froehlke**. We assume it will be next week. Yes, sir.

The **Chairman**. I thank you very much, and your entire statement will be made a part of the record.

Mr. **Froehlke**. Thank you.

STATEMENT OF MORTON A. MYERS, DIRECTOR OF THE PROGRAM ANALYSIS DIVISION, GENERAL ACCOUNTING OFFICE, WASHINGTON, D.C.

Mr. **Myers**. On my right is Natwar Gandhi, who led the GAO team performing work on modified coinsurance for the Joint Committee on Taxation. In charge of our Economic Analysis Unit, on my left, is Craig Simmons.

We are pleased to be here today to discuss our ongoing work in the area of modified coinsurance. This work was undertaken at the request of the Joint Committee on Taxation and is an outgrowth of earlier work we did on the special provisions of the Internal Revenue Code under which life insurance companies are taxed.

By entering into modified coinsurance agreements under section 820 of the Internal Revenue Code, some insurance companies—most notably the very large mutual companies—are able to convert investment income on which they pay taxes into underwriting gains on which they pay little, if any, taxes. This was not the intent of Congress when section 820 was included in the Code. It was intended to avoid possible double taxation when these coinsurance arrangements are used. Without a section 820 election double taxation could occur because both the original insurer and the company sharing the risk would be subject to tax on some of the same income.

To study the section 820 problem, we used a sample of 42 large life insurance companies—24 mutuals and 18 stocks. In 1980 these companies held 73 percent of the industry's assets, about 60 percent of insurance in force, and collected about 54 percent of the industry's premiums. We are confident that our sample companies pay the bulk of the industry's Federal income taxes. Our findings to date indicate:

For our sample companies, the amount of modified coinsurance reported jumped from about $7 billion in 1979 to about $147 billion in 1980. Of this increase, the 10 largest mutual companies accounted for about $112 billion, or about 80 percent.

Our sample companies reduced their tax burdens in 1980 from the prior year by about $625 million. However, when we break this down between mutual and stock companies, we discover that the 10 largest mutuals accounted for $558 million, or 90 percent of this reduction.

When we project the entire industry's tax burden, we estimate a 1980 revenue loss of approximately $1.5 billion, a drop of about 37 percent from what the companies would have paid had they not elected section 820. We also estimate a similar revenue loss of some $3.4 billion, or about 74 percent, in 1981.

Elimination of section 820 would no doubt eventually correct the current reduction of enormous amounts of Federal income taxes. However, we believe its elimination could reintroduce the problem of double taxation. Furthermore, we believe that the problem of section 820 should be viewed in the larger context of the Life Insurance Company Income Tax Act of 1959. In this regard, it is important that the problem of section 820 be considered in light of the substantially changed economic conditions in which the industry currently operates. Inflation and the high interest rates of recent years are dramatically different from those that existed in 1959. Because of these changed conditions the 1959 act has not operated in the manner originally envisioned. We are very willing to assist this committee in any way we can to correct this problem.

At this time, Mr. Chairman, we will be happy to be responsive to any questions you may have.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Boren.

Senator BOREN. Mr. Myers, you mentioned that the problem with MODCO in section 820 has to be viewed not in isolation but in terms of the total act because of changed economic conditions, the rate of inflation, rates of interest, and so on.

Can you explain how that has affected the total tax burden of the industry? Over the past, say, 15 years, how has the share of corporate tax been impacted in terms of the insurance industry by these changed economic conditions?

Mr. MYERS. What happened: In 1959, sir, when the act was designed and inflation and interest rates were much more modest than those of today, interest rates caused a greater share of total investment income of insurance companies to be taxed.

I do not have, I believe, insurance industry numbers as a proportion or ratio of all corporate tax.

Senator BOREN. I just wonder how that has changed since 1959, if it has increased since 1959 because of the changed economic conditions? In other words, I wonder if the share of corporate tax paid by the industry has increased since 1959?

Mr. MYERS. I have seen a recent estimate that indicates the life insurance industries contribute about 5 percent of all corporate taxes in this country. I believe that is the most current number I have seen on that.

Senator BOREN. That would be an increase, then, because I think it was only around 2 percent or something like that back when the 1959 act was first written.

Mr. MYERS. Then, indeed, that would be an increase.

Senator BOREN. So you think we should try, that whatever we do this year we should eventually come back to looking at a revision of the entire act, or at least put this in perspective in terms of what it does to the entire act?

Mr. MYERS. Yes, we do. We are particularly in favor of that in view of the most recent proposed ruling published by IRS which seems to stop our first order of concern, the drain or loophole point, which now, I think, permits time to look at it in context with the rest of the provisions of the act.

The CHAIRMAN. It seems to me from what you have told us that the primary purpose of life insurance companies entering into these modified coinsurance arrangements was to save tax dollars. If that is the case, why has the Internal Revenue Service permitted these transactions for this long?

Mr. MYERS. It is hard to say with certainty, Senator. We do know that in September of 1980, some 14 or so months ago, they stopped issuing rulings on MODCO, indicating to us at least some intelligence or concern with what was already transpiring. I cannot account for the time between September 1980 and March 16, just this Tuesday, when they indeed did publish a proposed rule. And interestingly enough, if I read that proposal correctly, if it is effected it will be effective this morning, March 18. And perhaps the hearing had a lot to do with that. I don't know. But it took longer than I would have guessed or imagined.

The CHAIRMAN. Well, as I understand, the mutual companies have reduced their tax bill to a far greater extent than the stock companies. Is that your interpretation?

Mr. MYERS. Yes, that is right.

The CHAIRMAN. Why is that?

Mr. MYERS. They have more investment income. It is basically that simple. They are in a position to take greater advantage of this particular utilization of section 820, just by sheer volume of investment income.

The CHAIRMAN. And the big winners were Prudential and Metropolitan; is that right?

Mr. MYERS. Yes, that is right. Of the $625 million reduction which is for the entire sample of 42 companies from 1979 to 1980, what we find is that the 10 largest mutuals accounted for something on the order of $558 million of that, and only 2 mutuals, Prudential and Metropolitan, accounted for $525 million of basically that entire year's action. So, overwhelmingly, the larger you are in terms of investment income, the greater the benefit.

The CHAIRMAN. So about 10 companies had about 90 percent of the tax reduction?

Mr. MYERS. About 90 percent is correct.

The CHAIRMAN. And two companies had——

Mr. MYERS. A little more than 80 percent.

The CHAIRMAN. 80 percent.

Mr. MYERS. Yes, 80 to 85 percent.

The CHAIRMAN. Well, in light of your statement, are there any other parts of the code that deal with the life insurance companies that deserve special scrutiny at this time?

Mr. MYERS. Yes; we did earlier work on the 1959 act, not particularly focusing on section 820. There are things that should be looked at in the computational area; there are things that should be looked at in the definitional area—fundamental basic things: The definition of taxable income in the life insurance industry should be reexamined in light of the changes in over two decades. It is a dynamic industry, Mr. Chairman. There are new product lines. The economy is different. And the act is an intricate act. It is a complex act. It is difficult with great assurance to push one or two buttons and be absolutely certain we haven't adversely affected other implications in the act, other sections in the act.

The CHAIRMAN. Thank you very much.

As you have heard the previous witnesses, there will be a bill, I understand, introduced next week, and we will be asking you to take a look at that along with the joint committee and our own staff to see if we can work out some temporary provision to pick up some revenue.

Senator Bradley, do you have a question?

Senator BRADLEY. No, I don't, Mr. Chairman.

The CHAIRMAN. As I understand, the information concerning Metropolitan and Prudential is a matter of public record.

Mr. MYERS. Oh, yes, I believe the source of that data were the filings with the State regulatory commissions as well as certain information from the A. M. Best Service. That's right, sir.

The CHAIRMAN. Thank you very much.

Mr. MYERS. Thank you.

[The prepared statement follows:]

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WASHINGTON, D. C. 20548

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STATEMENT OF

MORTON A. MYERS

DIRECTOR, PROGRAM ANALYSIS DIVISION

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON

MODIFIED COINSURANCE

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our ongoing work in the area of modified coinsurance. This work was undertaken at the request of the Joint Committee on Taxation and is an outgrowth of earlier work we did on the special provisions of the Internal Revenue Code under which life insurance companies are taxed.

By entering into modified coinsurance agreements under Section 820 of the Internal Revenue Code, some insurance companies--most notably the very large mutual companies--are able to convert investment income on which they pay taxes into underwriting gains on which they pay little, if any, taxes. This was not the intent of Congress when section 820 was included in the code. It was intended to avoid possible double taxation when these coinsurance arrangements are used.

Without a section 820 election double taxation could occur because both the original insurer and the company sharing the risk would be subject to tax on some of the same income.

To study the section 820 problem, we used a sample of 42 large life insurance companies (24 mutuals and 18 stocks). In 1980 these companies held 73 percent of the industry's assets; about 60 percent of insurance in force; and collected about 54 percent of the industry's premiums. We are confident that our sample companies pay the bulk of the industry's Federal income taxes. Our findings to date indicate:

--For our sample companies, the amount of modified coinsurance reported jumped from about $7 billion in 1979 to about $147 billion in 1980. Of this increase the ten largest mutual companies accounted for about $112 billion or about 80 percent.

--Our sample companies reduced their tax burdens in 1980 from the prior year by about $625 million. However, when we break this down between mutual and stock companies we discover that the ten largest mutuals accounted for $558 million or 90 percent of this reduction.

--When we project the entire industry's tax burden, we estimate a 1980 revenue loss of approximately $1.5 billion, a drop of about 37 percent from what the companies would have paid had they not elected section 820. We also estimate a similar revenue loss of some $3.4 billion or about 74 percent in 1981.

Elimination of section 820 would no doubt eventually correct the current reduction of enormous amounts of Federal income taxes. However, we believe its elimination could reintroduce the problem of double taxation. Furthermore, we believe that the problem of section 820 should be viewed in the larger context of the Life Insurance Company Income Tax Act of 1959. In this regard, it is important that the problem of section 820 be considered in light of the substantially changed economic conditions in which the industry currently operates. Inflation and the high interest rates of recent years are dramatically different from those that existed in 1959. Because of these changed conditions the 1959 Act has not operated in the manner originally envisioned. We are very willing to assist this committee in any way we can to correct this problem.

At this time we will be happy to answer any questions you may have.

Table 1

Comparison of Sample with Industry 1980
($000,000,000 omitted)

	U.S. Life Companies	Sample	Percent of Industry
Number of Companies	1,948	42	2.2%
Assets	$ 479.210	$ 349.800	73.0%
Insurance in Force	4,029.877	2,396.859	59.5
New Insurance Issued	596.738	320.220	53.7
Premiums	94.225	55.397	58.8

Sources: Life Insurance Fact Book 1981, and various Best's Review Statistical Studies.

Table 2
Modified Coinsurance Reported
(000,000,000 omitted)

	1979	1980	Dollar Change	Percent Change
Prudential	$ -	$ 12.860	$ 12.860	*
Metropolitan	-	39.657	39.657	*
10 largest mutuals	1.289	112.871	111.582	8,656
24 sample mutuals	6.446	128.259	121.813	1,890
10 largest stocks	-	15.243	15.243	*
18 sample stocks	.348	18.527	18.179	5,224
42 sample companies	6.794	146.786	139.992	2,061

*undefined

Source: Annual Statements, various years.

Figure 1

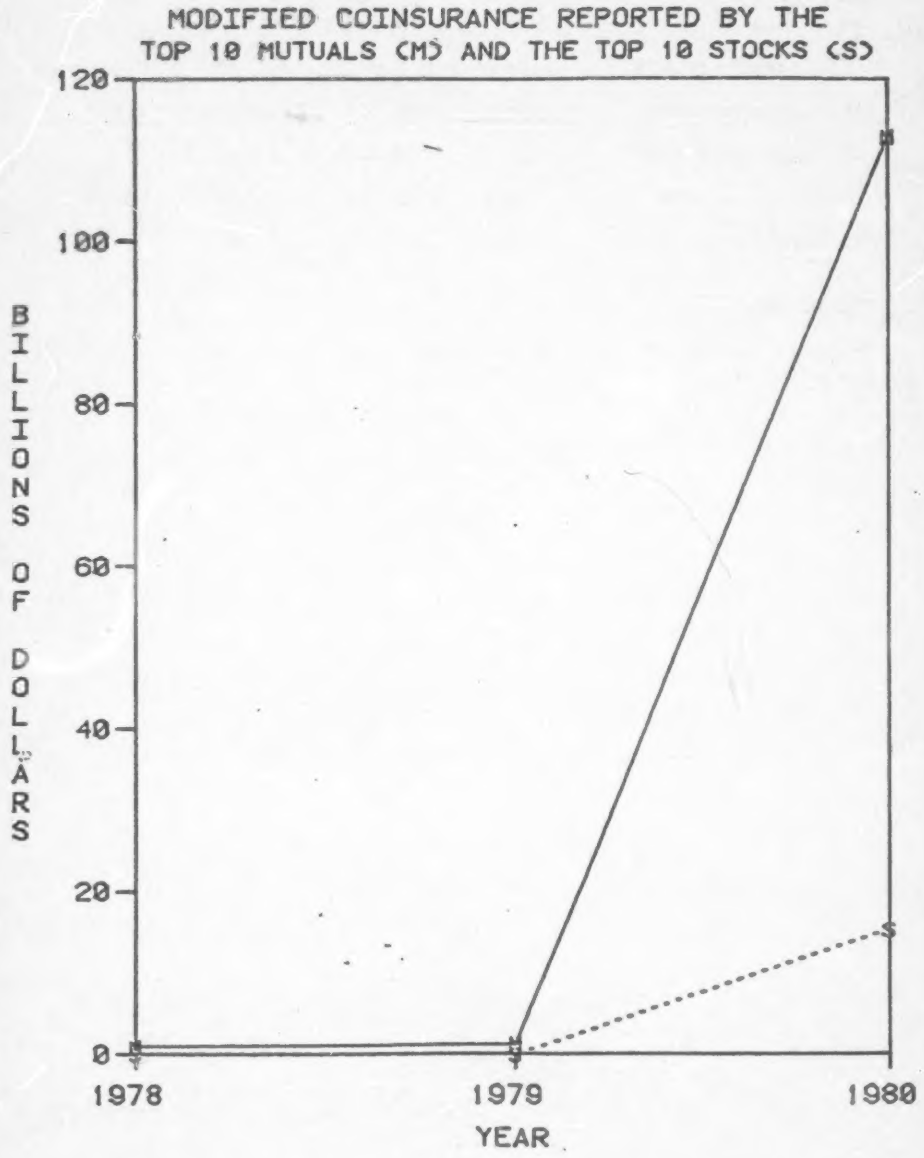

MODIFIED COINSURANCE REPORTED BY THE
TOP 10 MUTUALS (M) AND THE TOP 10 STOCKS (S)
BILLIONS OF DOLLARS
120
100
80
60
40
20
0
1978
1979
1980
YEAR
M
S

Figure 2

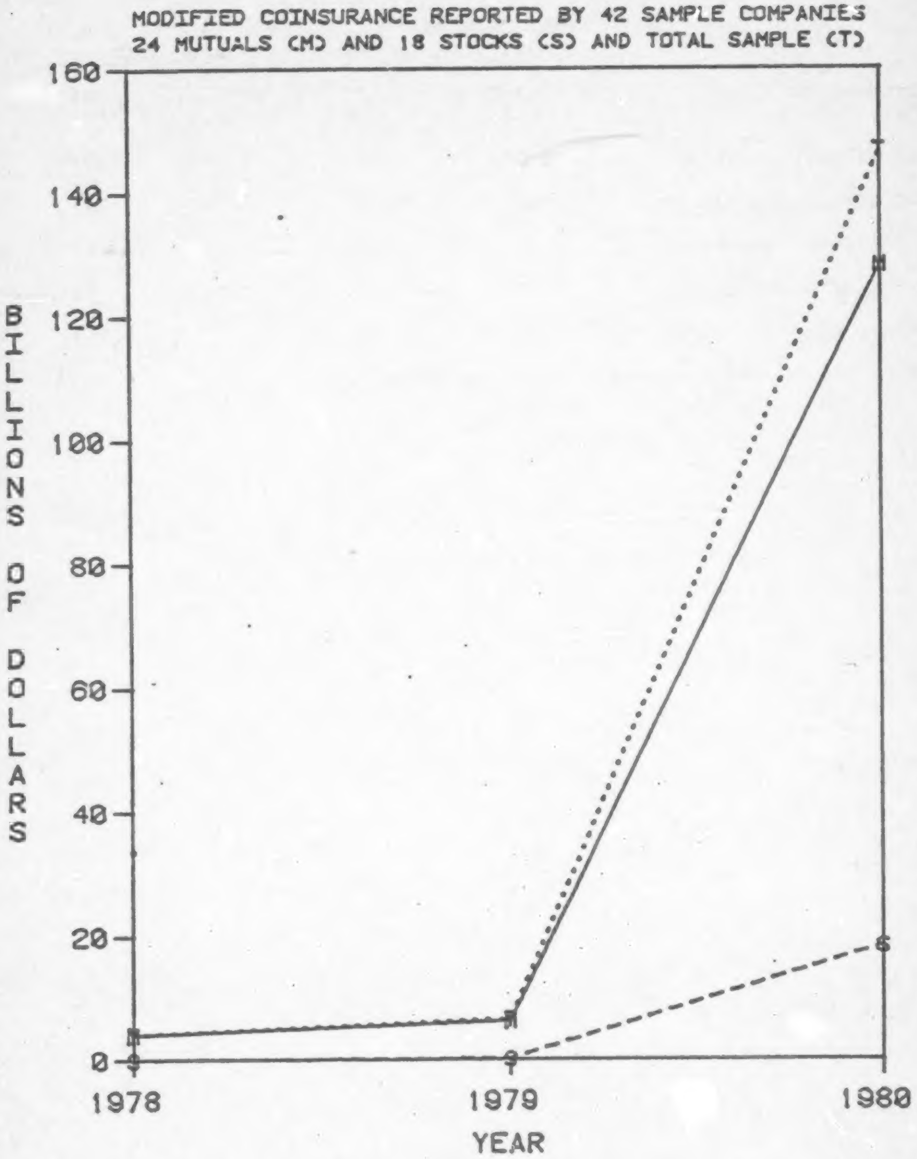

MODIFIED COINSURANCE REPORTED BY 42 SAMPLE COMPANIES
24 MUTUALS (M) AND 18 STOCKS (S) AND TOTAL SAMPLE (T)
BILLIONS OF DOLLARS
160
140
120
100
80
60
40
20
0
1978
1979
1980
YEAR
M
S
T

Table 3

Federal Income Taxes Incurred
(000,000,000 omitted)

	1979	1980	Dollar Change	Percent Change
Prudential	$ .380	$.120	$(.260)	(68)%
Metropolitan	.343	.078	(.265)	(77)
10 largest mutuals	1.524	.966	(.558)	(37)
24 sample mutuals	1.837	1.247	(.590)	(32)
10 largest stocks	.535	.495	(.040)	(7)
18 sample stocks	.670	.635	(.035)	(5)
42 sample companies	2.507	1.882	(.625)	(25)

Source: Annual Statements, various years.

Figure 3

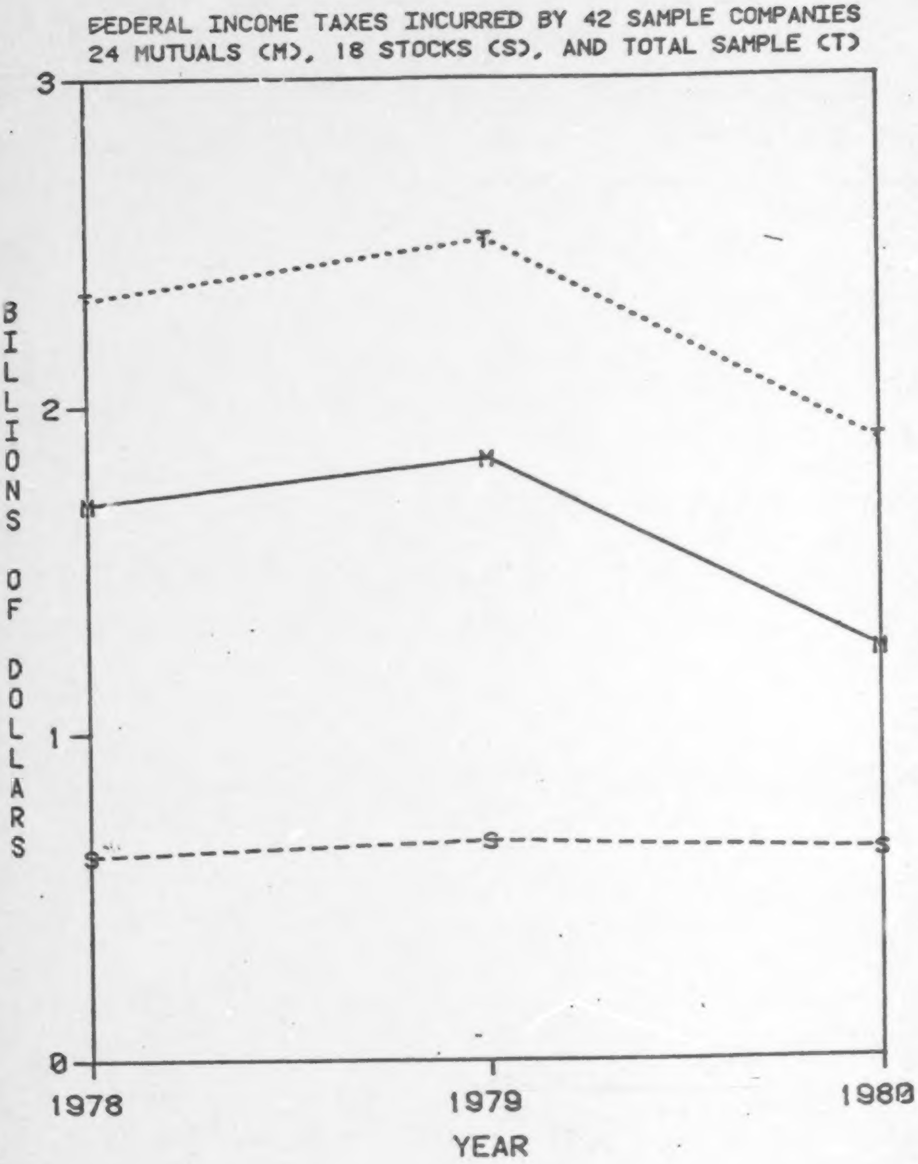

FEDERAL INCOME TAXES INCURRED BY 42 SAMPLE COMPANIES
24 MUTUALS (M), 18 STOCKS (S), AND TOTAL SAMPLE (T)
3
2
1
0
BILLIONS OF DOLLARS
T
T
T
M
M
M
S
S
S
1978
1979
1980
YEAR

Table 4
Federal Income Taxes Incurred
(000,000,000 omitted)

	1979	1980	Percent Change	1981	Percent Change
10 largest mutuals	$1.524	$ .966	(36.61)%	$ .615	(36)%
10 largest stocks	.535	.495	(7.48)	.512	3

Source: Annual Statements, various years.

Figure 4

FEDERAL INCOME TAXES INCURRED FOR THE TOP 10 MUTUALS (M) AND THE TOP 10 STOCKS (S)

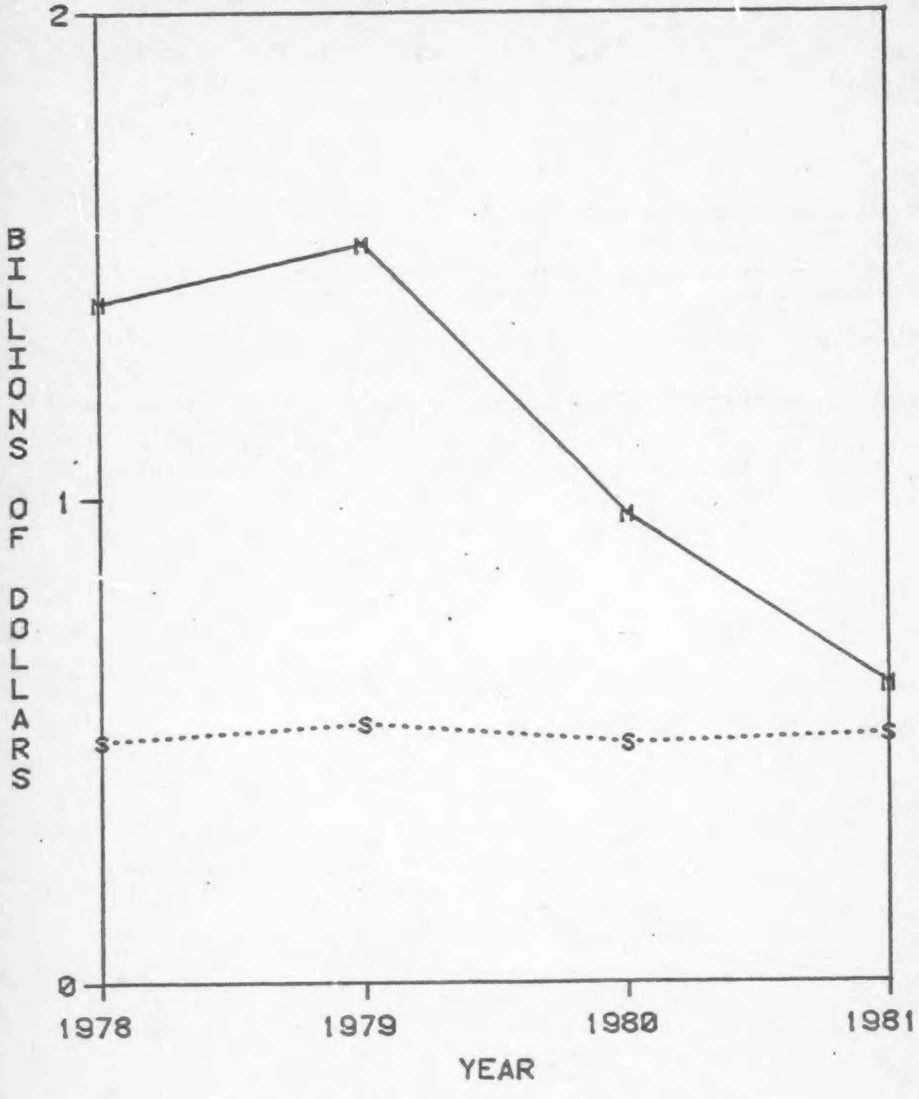


Table 5
Estimated Revenue Losses
(000,000,000 omitted)

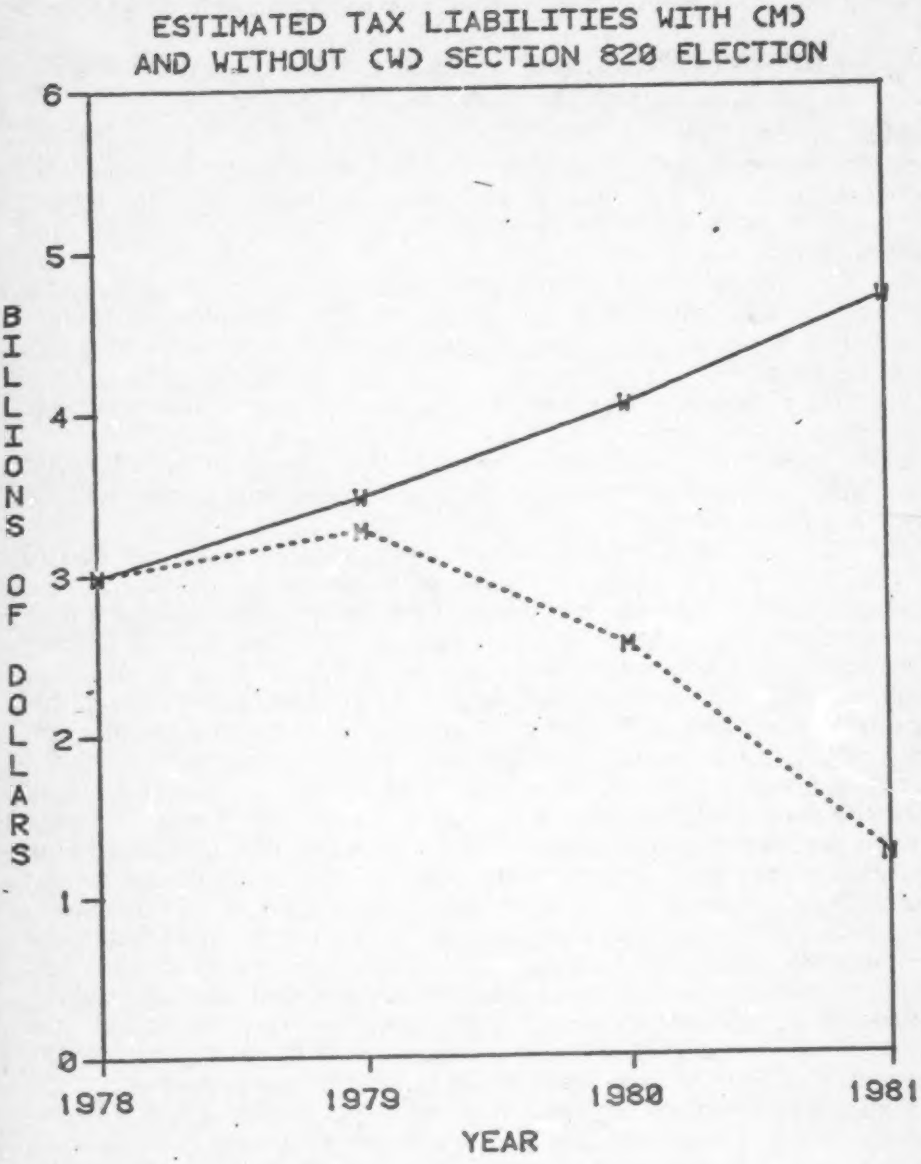
	Estimated Taxes Assuming No section 820	Estimated Taxes Incurred	Estimated Revenue Losses
1978	$2.994 a/	$2.994 a/	$ -
1979	3.479 b/	3.269 a/	.210
1980	4.043 b/	2.551 a/	1.492
1981	4.699 b/	1.242 c/	3.457

a/Life Insurance Fact Book 1981, p. 64.

b/Projected at an annual growth rate of 16.21 percent, the geometric mean of the growth rates of the preceding three years. This compares to the ACLI/industry estimate of 15.0 percent annual growth rate.

c/GAO estimate based on a statement of Deputy Treasury Secretary R. T. McNamar, "In 1981 Treasury received only 38 cents for every dollar it received in 1979 from the life insurance industry..." "Daily Tax Report," (Bureau of National Affairs: Washington, DC) March 1, 1982, p. G-4.

Figure 5


ESTIMATED TAX LIABILITIES WITH (M)
AND WITHOUT (W) SECTION 820 ELECTION
BILLIONS OF DOLLARS
0
1
2
3
4
5
6
1978
1979
1980
1981
YEAR
W
M

The CHAIRMAN. Next we have a panel consisting of Mr. Padwe and Mr. Lerner. Mr. Lerner is a partner, Ernst & Whinney; Mr. Padwe, associate national director, tax services, Touche Ross & Co.

Let's see, do you have some order in which you wish to proceed?

STATEMENT OF HERBERT J. LERNER, PARTNER, ERNST & WHINNEY, WASHINGTON, D.C.

Mr. LERNER. Yes.

My name is Herbert J. Lerner. I am a partner in charge of tax services for Ernst & Whinney, and I am accompanied today by my partner, Richard S. Antes, who is a life insurance tax specialist, seated on my left.

I will summarize our specific comments today on three subjects covered in the Treasury's tax proposals: The completed contract method of accounting, the new corporate minimum tax, and modified coinsurance.

I would appreciate the inclusion in the record of our complete statement.

The CHAIRMAN. It will be included in the record. In fact, I would just make one blanket request that all statements today will be made a part of the record.

Mr. LERNER. With respect to the completed contract method of accounting, we are opposed to the elimination of the completed contract method and its replacement by the percentage of completion method or the progress payment method. We do not believe that either of those methods as conceived and applied from a tax standpoint should be mandated as the only acceptable methods for long-term contractors. Either of those methods may create substantial inequities for certain contractors.

The percentage of completion method is based on estimates of both the final contract sales price and the cost to perform. Contract cost to perform can include provisions for warranty, estimated subcontractor overruns or underruns, and procurement estimates for which final prices may not have been negotiated in advance with the vendor. This process requires a substantial amount of judgment to make the determination as to the portion of the work that has been completed. The IRS has historically resisted the attempt by taxpayers to use estimates in accounting for income and deductions. Thus, it seems inconsistent to require that taxpayers use the percentage of completion method for tax reporting purposes.

Under the progress payment method taxpayers would not be required to use estimates, but they would be required to include in income any advance payments on the contracts, loans from the purchaser, or loan proceeds where the contracts are used as security for the loans. This is a novel concept of taxing amounts when they are received, sort of a cash-flow approach, and it raises serious basic issues since it may have the effect of taxing capital.

For example, under a fixed-price incentive contract with a cost-sharing clause and an estimated cost underrun at completion a taxpayer could incur a tax liability on a portion of amounts ultimately to be refunded to the customer.

Alternatively, if the contract terms call for an advance of funds late in the tax year and expenses to be incurred in the early part of the subsequent year, the contractor would incur a tax liability on hypothetical income.

At best, it appears the Treasury's proposal is only a piecemeal adoption of the percentage of completion method since it ignores a basic financial reporting concept that applies both under the percentage of completion and the completed contract method; that is, recognition of the entire loss on a contract in a year when the loss first becomes evident. We fail to see how the Treasury's proposal will necessarily result in a clearer reflection of income, unless a loss is recognized for tax purposes when it becomes evident that a contract will result in a loss.

The difficulty of estimating is not a problem attendant to the completed contract method.

Finally, we would acknowledge that if there are perceived abuses, some of which we would agree with in the application of the completed contract method, rather than eliminating that method that has been in place for 64 years, the IRS should use its current regulatory authority to correct those abuses.

Nevertheless, if changes are required—that is, a mandatory change from the completed contract method to the percentage of completion or progress payments method—we would urge that the legislation provide effective transitional rules. And we in our detailed statement include two suggestions, one dealing with the traditional section 41 adjustment, spreading the adjustment over a 10-year period, which is not contained in the proposal as submitted; and second, the alternative use of a suspense account approach for dealing with presently deferred amounts of income.

With respect to the corporate minimum tax, that new tax proposal will add another layer of complexity to our tax laws. We believe such a drastic change to our system which will reverse or limit the utility of many tax incentives, some of which have been in the law for many years and others of which were just legislated 8 months ago, should not be made without compelling reasons and only if it permits taxpayers to adjust to the change on a prospective basis.

For example, decisions by banks to invest in tax-exempt securities are usually the product of very long range planning. Expected yields from investments of this type are carefully calculated and appraised before a decision to invest is made. To impose a minimum tax now on the interest deductions allocable to such securities that were acquired years ago seems to us to be unfair. We believe it may be better for Congress to reexamine underlying tax incentive provisions, which examination is traditionally done on a prospective basis, rather than impose an alternative minimum tax that has a retroactive impact.

On the modified coinsurance, the administration proposal to repeal section 820, dealing with the optional treatment of modified coinsurance contracts, and to clarify the treatment of experience refunds should not be considered in isolation from the other aspects of taxation of life insurance companies. Instead, we recommend that temporary measures be developed which are equitable to the industry, provide an adequate level of tax, and preserve the opportunity for economic balance with the industry as was done in 1959. This should be followed by an all-out effort as described by the insurance industry representatives in the previous discussion.

We thank you for your attention to our comments, and would be pleased to respond to any questions you may have.

The CHAIRMAN. Thank you.

[The prepared statement follows:]

STATEMENT OF ERNST & WHINNEY ON THE TREASURY DEPARTMENT'S TAX REVISION PROPOSALS RELEASED FEBRUARY 26, 1982

We appreciate this opportunity to comment on the 1982 tax proposals for income tax revision.

Ernst & Whinney is an international firm of Certified Public Accountants with more than 300 offices in 70 countries. We provide accounting, auditing, tax and management consulting services to corporate, individual and other clients engaged in various business and governmental activities. However, none of our comments are made on behalf of specific clients of our firm.

General Comments

Our comments have been designed to provide a meaningful contribution toward the achievement of the primary objectives of the Administration's current tax proposals -- to make sure that our tax system is running efficiently and fairly. In that connection, we believe that the goals of our system should continue to provide:

- Incentives for greater productivity, capital investment and employment;
- Increased equity or fairness in its application; and
- Simplification of our tax system.

Although we appreciate the desirability of addressing the issue of tax revisions to alter the major imbalance in the federal budget, as a practical matter, we question whether it is realistic or prudent to attempt to accomplish major tax revision this year. While we recognize that expediency may suggest tax revisions at this time, it may be more appropriate in the long run to subordinate expediency for more carefully considered and durable major changes in our tax system.

The frequency of major tax legislative changes has been increasing in recent years, and as a consequence, taxpayers are not given adequate time to adjust to the new and often complicated rules of our tax system. Too often, hastily enacted technical provisions have to be corrected, modified, delayed or repealed before they take effect as originally passed. For this reason, we believe any changes should be kept to a minimum and be simple in implementation and compliance.

Our specific comments are summarized below, and are covered in detail in the succeeding portion of this statement.

* * *

SUMMARY OF POSITION

Completed Contract Method

Under the Treasury's legislative proposal, taxpayers would not be allowed to use the completed contract method of accounting for contracts entered into after February 26, 1982. Under the proposal, taxpayers would be required to use either the percentage of completion method or the progress payment method.

We are opposed to the elimination of the completed contract method and its replacement by either the percentage of completion method or the progress payment method. We do not believe that either of those methods as conceived and applied from a tax standpoint will more clearly reflect taxable income. The percentage of completion method is based on estimates of both the final contract sales price and the cost to perform. Under the progress payment method, taxpayers would not be required to use estimates, but they would be required to include in income any advance payments on the contracts, loans from the purchaser, or loan proceeds where the contracts are used as security for the loans. This novel concept of taxing amounts when they are received -- a cash flow approach -- raises serious basic issues since it may have the effect of taxing capital.

Corporate Minimum Tax

Effective January 1, 1983, the present add-on corporate minimum tax on certain items of tax preference would be replaced with a new 15 percent alternative minimum tax on "adjusted corporate profits" in excess of $50,000, which must be paid only if it exceeds the regular corporate income tax.

In our opinion, the minimum tax proposals will bring a complexity to our tax laws that is not needed at this time. It will not be simple in execution and will result in inequities. Such a drastic change in our tax system, which will reverse or limit the utility of many tax incentives -- some of which have been in the tax law for many years and others which were enacted only eight months ago -- should not be made without compelling reasons and only if it contains fair transitional rules that will permit taxpayers and other affected parties to adjust to the changes on a prospective basis.

We believe it would be better for Congress to re-examine the underlying tax relief or incentive provisions, which is traditionally done on a prospective basis, rather than impose an alternative minimum tax that has a retroactive impact.

Modified Coinsurance

The Administration proposals to repeal section 820 dealing with the optional treatment of modified coinsurance contracts and to clarify the treatment of experience refunds should not be considered in isolation from the other aspects of taxation of life insurance companies. Instead, we recommend that temporary measures be developed which are equitable to the industry, provide for an adequate level of tax, and preserve the opportunity for economic balance within the industry. This should be followed by an all-out effort by the Treasury, Congress, and the life insurance industry itself to study the required changes to Subchapter L that will result in fair and equitable taxation of the life insurance industry in today's environment.

COMPLETED CONTRACT METHOD OF ACCOUNTING

Current Law

Presently, a taxpayer may use either the percentage of completion method or the completed contract method for long-term contracts. A taxpayer also may use any other acceptable accounting method for its long-term contracts, such as the accrual method or the accrual shipments method under section 446 of the Internal Revenue Code.

Proposed Changes

Elimination of the Completed Contract Method: Under the legislative proposal, taxpayers would not be allowed to use the completed contract method of accounting for contracts entered into after February 26, 1982.

Required Methods: Under the proposal, taxpayers would be required to use either the percentage of completion method or the progress payment method.

- Percentage of Completion Method - Under this method, taxpayers are required to report income based on the percentage of work completed. Costs may be deducted in the year paid or incurred.
- Progress Payment Method - Under the progress payment method, a taxpayer must include in income all payments when the right to receive such payments accrues. This would include any amounts the taxpayer is entitled to receive under the contract. A taxpayer would also be required to include in income any amounts received in the form of loans from the customer or loans from third parties where the contract was used to secure the loan. This method would also contain a special rule for advance payments received or accrued before work on a contract has commenced.

  Under the progress payment method, income will be reported on a contract by contract basis. Income will be recognized during the course of the contract when payments received or accrued exceed the total current and previously unclaimed costs. Losses will be recognized only if the costs incurred exceed the total amount the taxpayer has the right to receive under the contract.

Under the progress payment method a taxpayer would be required to allocate the majority of its costs to the contract. Such costs would be deducted only when the taxpayer has the right to receive payment under the contract and then only to the extent of such payment. The only exception to this rule is with respect to the following costs which would be treated as period costs:

(a) General marketing, selling and advertising expenses;

(b) Bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer;

(c) Research and experimental expenses neither directly attributable to particular long-term contracts in existence at the time such expenses are incurred nor incurred under any agreement to perform such research or experimentation;

(d) Losses under section 165 and the regulations thereunder;

(e) Depreciation and amortization on idle equipment and facilities;

(f) Income taxes attributable to income received from long-term contracts;

(g) Pension contributions to the extent that they represent past service costs; and

(h) Costs attributable to strikes.

Ernst & Whinney Comments

Advantages of Completed Contract Method. The completed contract method has an important place in the reporting of income under the Internal Revenue Code and has been an acceptable concept of tax reporting since 1918. In fact, a substantial number of companies also use this method for financial reporting purposes. Although it tends to bunch income in the year of completion, there are enough advantages to justify the continued permissibility of this method.

The completed contract method recognizes revenue when the earning process is complete or virtually complete. The method allows the contractor to avoid having to forecast future events -- often a very difficult problem in the construction industry. Events and circumstances can often create estimated contract fluctuations during the period of performance. Therefore, for sound tax policy reasons, the completed contract method recognizes the inherent risks and uncertainties of contract performance that face the typical contractor.

Many other contractors do, in fact, have a significant profit risk in their contracts that is not resolved until final completion of the contract. Contracts that result in losses may not be identified until the final phase of completion. To prohibit use of the completed contract method for these kinds of contracts is not desirable.

Finally, we believe that if there are perceived abuses in the application of the completed contract method, rather than eliminating a method that has been in place for 64 years, the IRS should use its current regulatory authority to correct those abuses.

Disadvantages of Percentage of Completion Method. Under the Treasury proposal, taxpayers would be required to use the percentage of completion method or the progress payment method for long term contracts. We do not believe that either method as conceived and applied from a tax standpoint will necessarily more clearly reflect a taxpayer's taxable income. The percentage of completion method is based on estimates of both the final contract sales price and the cost to perform. Sales price estimates include, but are not limited to, consideration of items such as:

(1) Contract change orders, priced or unpriced which may or may not have been negotiated with the customer.

(2) The impact of any cost performance incentive fee provisions.

(3) The impact of any technical performance incentive fee provisions.

(4) The impact of any unilateral award fees.

(5) Estimated unallowable costs which are subject to future negotiations with the customer.

Contract costs to perform can include provisions for warranty where appropriate, estimated subcontractor overruns or underruns, and procurement estimates for which final prices may not have been negotiated in advance with the vendors. This process requires a substantial amount of judgment to make the determination as to the portion of the work that has been completed.

The IRS has historically resisted the attempt by taxpayers to use estimates in accounting for income and deductions. Thus, it seems inconsistent to require that taxpayers use the percentage of completion method for tax reporting purposes. Furthermore, under the percentage of completion method taxpayers may be required to report income and pay taxes even though the contract terms and conditions may preclude billing the customer until some time in the future. Moreover, the percentage of completion method as applied for tax purposes does not generally permit current deductibility of anticipated losses on partially completed contracts.

Disadvantages of the Progress Payments Method. Under the progress payment method, taxpayers would not be required to use estimates, but they would be required to include in income any advance payments on the contracts, loans from the purchaser, or loan proceeds where the contracts are used as security for the loans. This concept of taxing amounts when they are received raises serious basic issues, since it may have the effect of taxing capital.

The progress payment method could result in tax payments and tax liability being determined on the basis of the contract billing terms or cash flow rather than on the profitability of the contract. Taxpayers may be in a situation where they have a loss contract, but because they have received advance payments or there are progress billings in excess of costs to date, they would be reporting income on such amounts. For example under a fixed-price incentive contract, with a cost sharing clause and an estimated cost underrun at completion, a taxpayer could incur a tax liability on a portion of amounts ultimately to be refunded to the customer. Alternatively, if contract terms call for an advance of funds late in a tax year for costs to be incurred in the early part of the subsequent tax year the contractor would incur a tax liability on hypothetical income.

Tax Reporting vs. Financial Accounting. The Treasury proposal implies that the percentage of completion method is the preferred method for tax reporting and for financial accounting purposes. It seems to us that the Treasury proposal is founded on the presumption that financial reporting criteria should be used to govern tax reporting for long-term contracts. However, the objectives of financial reporting and tax reporting are frequently not the same. In fact, the Financial Accounting Standards Board (FASB) states in its Statement of Financial Accounting Concepts No. 1 that

> "Investors, creditors, and others may use reported earnings and information about the elements of financial statements in various ways to assess the prospects for cash flows. They may wish, for example, to evaluate management's performance, estimate "earning power," predict future earnings, assess risk, or to confirm, change, or reject earlier predictions or assessments."

In addition to the FASB, other accounting guidelines have evolved from various regulatory or standard setting bodies. These include the Cost Accounting Standards Board (CASB), Government Accounting Standards Board (GASB), Department of Defense (DOD), General Services Administration (GSA), and Interstate Commerce Commission (ICC). Each of these organizations has issued its own separate accounting and costing rules which may or may not be symmetrical with financial or tax reporting.

On many occasions, the Supreme Court has stated that the objectives of taxation and financial reporting differ and, therefore, the treatment of a particular item does not have to be consistent. A contractor may use its financial statements for loan financing, a bonding rating, shareholder reporting, etc. However, these purposes are entirely different from the objective of reporting income for tax purposes.

At best it appears that the Treasury proposal is only a piecemeal adoption of the percentage of completion method, since it ignores a basic financial reporting concept that applies under both the percentage of completion and completed contract methods -- recognition of the entire loss on a contract in the year when the loss first becomes evident. The Treasury proposal would recognize income under the percentage of completion method, but would not allow for losses under that method. We fail to see how Treasury's proposals will necessarily result in a clearer reflection of income unless a loss is recognized for tax purposes when it becomes evident that a contract will result in a loss.

Allocation of Costs to Contracts

Current Law

Currently a taxpayer must allocate to a contract all direct costs and those indirect costs which are incident to and necessary for the performance of a particular long-term contract. This would include rent, utilities, maintenance, etc. Costs which are not required to be allocated, referred to as period costs, include interest, selling expenses, bidding expenses, research and development, and other similar-costs which benefit the taxpayer's activities as a whole.

Proposed Change

Under the Treasury proposal, taxpayers would be required to allocate to contracts in progress not only those costs presently required to be allocated but some costs that were previously treated as period costs. These costs would be deducted only as the related revenue from a contract is recognized. Thus, a taxpayer would be required to include not only all direct costs and indirect costs incident to and necessary for the performance of a particular long-term contract, but also certain other costs such as excess depreciation, bidding costs on successful contracts, general and administrative costs, research and development costs, interest, and employee benefit costs. Only the following costs would be excluded from this requirement.

(a) General marketing, selling and advertising expenses;

(b) Bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer;

(c) Research and experimental expenses neither directly attributable to particular long-term contracts in existence at the time such expenses are incurred nor incurred under any agreement to perform such research or experimentation;

(d) Losses under section 165 and the regulations thereunder;

(e) Depreciation and amortization on idle equipment and facilities;

(f) Income taxes attributable to income received from long-term contracts;

(g) Pension contributions to the extent that they represent past service costs; and

(h) Costs attributable to strikes.

Ernst & Whinney Comments

The proposed changes to the long-established costing rules would have the effect of putting contractors at a disadvantage compared to other taxpayers. The costing rules for the completed contract method of accounting are based on the tax accounting rules for inventories. The cost must be "incident to and necessary for" the long-term contract in order to be allocated directly to that contract. The "incident and necessary" test is present in the current regulations under the completed contract method, but its use there is derived from the regulations relating to inventory costing.

Under the inventory rules, the majority of the costs the Treasury now proposes to require to be capitalized are deducted currently as period costs. In fact, in Rev. Rul. 79-25, 1979-1 CB 186, the IRS argues that these costs should not be allocated to inventory, but should be treated as period costs. Period costs include either those costs that are not clearly related to the production of a particular item, or are incurred without actually benefiting future periods.

The proposal will add complexity to this area because it is unlikely that a number of these costs can be properly attributable to specific contracts. For example, interest expense may reflect the cost of raising working capital. Even if interest arises due to the financing of one contract, it is likely, especially with smaller contractors, that the loan proceeds will be used wherever they are needed in the business. Interest cannot on a realistic basis be attributed to one aspect of a business when in fact the proceeds to which it relates are used in other aspects of that business. Thus, according to the completed contract and inventory accounting rules and objectives, interest should be deducted currently. In addition, other taxpayers who have the same working capital needs can continue to deduct interest currently.

Furthermore, the new allocation rules may be inconsistent with the tax policy for allowing certain items as deductions. For example, the required capitalization of depreciation in excess of the amount reported for financial statements would be inconsistent with the reasons for enacting the new accelerated cost recovery rules under the Economic Recovery Tax Act.

Proposed Effective Date

The proposals would be effective for taxable years beginning after December 31, 1982. Taxpayers may continue to use the completed contract method of accounting for any contracts entered into on or before February 26, 1982. For those contracts entered into after such date, the taxpayer will be required to use the percentage of completion method or the progress payment method for all costs incurred and profits realized in taxable years beginning after December 31, 1982.

Ernst & Whinney Comments

Generally, the Service has required taxpayers to account for any changes in method of accounting by spreading the adjustment over an appropriate number of years. In fact, the Service in Rev. Proc. 80-51, 1980-2 CB 818, indicated that the section 481 adjustment, while necessary to prevent duplications or omissions of income or deductions, by its nature is distortive since it does not reflect the economic income of the year. Therefore, it requires taxpayers to spread the adjustment over an appropriate period of time. The proposed rule does not allow for this type of transition. Thus, we believe that taxpayers should be allowed to use a suspense account approach or a traditional adjustment period for any section 481 adjustment since these methods have been used in the past to account for adjustments and changes of methods of accounting.

While we do not believe the completed contract method should be eliminated, we believe the establishment of a suspense account for contracts in progress is the most equitable approach in the event the completed contract method is eliminated.

Suspense Account Adjustment. This approach has been used in other areas to deal with legislative changes in the treatment of certain items, *e.g.*, section 463 dealing with non-vested vacation pay and section 166(f) dealing with reserves for certain guaranteed debt obligations.

Under the suspense account approach, taxpayers would be required to establish a suspense account for those amounts that are currently deferred under the completed contract method. The amount in the suspense account would be included in income as a taxpayer's deferred profit falls below the level in the suspense account. See Exhibit A for an illustration of how the suspense account approach would work.

Section 481(a) Adjustment. An alternative to the suspense account approach would be to provide for a section 481(a) adjustment for any contracts in progress at the beginning of the year of change.

The adjustment would be computed based on the amount of work previously performed on contracts in progress at the beginning of the year of change and would be spread over 10 years. The section 481(a) adjustment approach provides a vehicle to prevent amounts from being duplicated or omitted. At the same time, it helps to ameliorate any distortion of income that would occur in the year of change.

EXHIBIT A

Illustration of Suspense Account Approach

Operation of Method: To prevent a doubling up of income in the first year that the completed contract method is eliminated, taxpayers would establish two accounts. The first account (the contracts in progress account) would be based on the amount of work performed on those contracts at the beginning of the year of change. For example, if a calendar year taxpayer had contracts in progress which ultimately would result in profits of $500,000 on January 1, 1983, and the contracts were all 50% complete, the opening balance in the account would be $250,000. Taxpayers would also establish a second account (the suspense account) in the same amount.

To prevent the permanent deferral of the amount in the suspense account, taxpayers would be required to include in income any reduction in the contracts in progress account at the end of any given year; that is, the suspense account is reduced in the amount by which the beginning balance of the suspense account exceeds the ending balance in the contracts in progress account. For example, assume the suspense account has an opening balance of $250,000 on January 1, 1983 and at the end of the year the taxpayer had only $200,000 in its contracts in progress account. Since the end of year balance of the contracts in progress account is less than the beginning balance in the suspense account (by $50,000), the taxpayer would include the $50,000 in income and would reduce the suspense account by $50,000. (This procedure might apply in future years to require restoration to income of the balance in the suspense account, pro tanto, as the taxpayer reduces its level of contracts in progress in those years.)

The following example illustrates the results of the use of the suspense account.

> Example: Corporation Y, a calendar-year taxpayer, reported income on the completed contract method with the contracts being completed in the year following the year they are started. Assuming Y changes to the percentage of completion method for 1983, the comparative results are as follows:

(1)	(2)	(3)	(4)	(5)
At the Close of —	Income Earned on the Percentage of Completion Method**	Suspense Account Balance Beginning of Year	Income or (Deduction) under Suspense Account	Total Income (2) + (5)
1982	125,000	-	-	-
1983	140,000	$125,000	-	$140,000
1984	110,000	125,000	$ 15,000	125,000
1985	130,000	110,000	(15,000)	115,000
1986	-0-*	125,000	125,000	125,000

* For illustrative purposes only.

** This column is the cummulative amount in the contracts in progress account.

In this case, the initial suspense account balance equals $125,000. At the close of 1984 there is a decrease of $15,000 in the suspense account balance. The taxpayer would be required to include this amount in income. For 1985 the beginning of the year suspense account balance ($110,000) is less than the end of the year contracts in progress account ($130,000) by $20,000. Only $15,000 of this amount is deducted and the suspense account balance is only increased to $125,000. For 1986 the beginning suspense account balance ($125,000) exceeds the closing contracts in progress account (-0-) by $125,000. This amount is includible in income in 1986.

NEW CORPORATE MINIMUM TAX

Current Law

Under present law, corporations must pay an add-on minimum tax equal to 15 percent of certain items of tax preference in excess of the greater of either $10,000 or 100 percent of the corporation's regular income tax liability. These items of tax preference are:

(1) 18/46 of net long-term capital gains;

(2) percentage depletion in excess of the adjusted basis of the property;

(3) depreciation in excess of straight line on low-income rental housing, non-recovery property, or 15-year real property;

(4) amortization of pollution control facilities in excess of regular depreciation;

(5) amortization of child care facilities in excess of regular depreciation; and

(6) reserves for losses on bad debts of financial institutions in excess of the reserves that would have been allowed on the basis of actual experience.

Proposed Changes

Effective January 1, 1983, the present add-on corporate minimum tax on certain items of tax preference would be replaced with a new 15 percent alternative minimum tax on "adjusted corporate profits" in excess of $50,000, which must be paid only if it exceeds the regular corporate income tax. No credits other than the foreign tax credit would be allowed to offset the new minimum tax. The excess of the minimum tax paid in any year over the regular corporate income tax liability calculated for that year can be carried over as a credit against the regular tax.

Adjusted corporate profits will be calculated by adding back to a corporation's taxable income (excluding NOL carryovers or carrybacks) the following expanded list of tax preference items.

(1) excess percentage depletion;

(2) accelerated depreciation on real property;

(3) amortization of certified pollution control facilities;

(4) amortization of child care facilities;

(5) reserves for losses on bad debts of financial institutions;

(6) intangible drilling costs;

(7) mining exploration and development costs;

(8) lessors' leasing benefits;

(9) deductions for debt to buy or carry tax-exempt securities;

(10) deferred DISC income;

(11) certain shipping income;

(12) amortization of motor carrier operating rights;

(13) excess interest on original discount bonds; and

(14) deductions for certain costs incurred with respect to long-term contracts.

Ernst & Whinney Comments

In our opinion the minimum tax proposal will bring a complexity to the tax law which is not needed at this time. Because of the special structure needed to impose a minimum tax of the type being proposed it is particularly burdensome to apply. The minimum tax produces significant complications, makes tax and financial planning more difficult, and as a result is directly contrary to tax simplification efforts that have been underway in Congress for the past several years.

The Treasury in its explanation of the new corporate minimum tax states that:

> "The existing "add-on" minimum tax applies to corporations that have reduced their tax liability through the use of designated tax deductions, but is not focused upon corporations that pay little or no regular income tax. The proposed corporate minimum tax would tax "corporate profits," as measured by regular taxable income plus certain special deductions . . . "

This statement would lead us to believe that there is a conceptual difference between the old add-on minimum tax and the new tax being proposed. We do not see it that way. The new tax although structured differently is nothing more than a tax on an expanded list of tax preference items. We view the proposed tax as a penalty on those businesses employing tax relief or incentive provisions that by themselves were considered appropriate and consistent with national goals by Congress and previous Administrations. This is not to imply that all these provisions should be sacrosanct forever.

In our opinion a far better approach for Congress to follow would involve the careful reconsideration of all previously enacted tax relief/incentive provisions. If Congress finds in view of changing economic conditions that these provisions are now too generous, not needed, or perhaps not generous enough then they should be revised accordingly. Of course, this will take time but we believe it is a far better approach and one that will restore investor confidence rather than undermine it.

Imposition of a new minimum tax will further undermine our economic recovery since long-term investment decisions require a high degree of certainty before investors will be willing to commit their funds. But perhaps even more important is the fact that the proposed minimum tax may affect business planning and decisions that in some cases were made long ago. For instance, decisions by banks to invest in tax-exempt securities are usually the product of long range planning. Expected yields from investments of this type are carefully calculated and appraised before a decision to invest is made. To impose a minimum tax now on securities that were acquired years ago seems to us to be most unfair. The decision making process to invest in drilling, mining exploration or planning with respect to exports and foreign operations is also the product of long range planning, and to impose a tax on these kinds of investments after they have been made seems similarly unfair.

The new proposed minimum tax will affect many industries adversely. In some cases these are the industries most in need of assistance. The following items which would be included as tax preferences in the new alternative minimum tax base suggest the need for consideration of special transitional or exception provisions:

(1) Intangible drilling costs - This item would include the deduction for intangible drilling and development costs of oil, gas and geothermal wells (other than dry holes) in excess of the amount allowable had the costs been capitalized and amortized on the straight line basis over 10 years. There would be no offset for the net income from the properties for the year, as there is under the minimum tax for individuals.

Effect: This item would directly impact the petroleum and natural gas drilling industry. Much of our country's energy resource development is accomplished by smaller independent drillers and refiners and these companies could be significantly impacted by the new provision. If this tax is imposed it may result in reduced drilling and exploration for new sources of energy.

(2) Mining exploration and development costs - This item would include deductions for mining exploration and development costs in excess of the amortization that would have been allowable on the straight line basis over 10 years.

Effect: One of the important national energy goals during the past decade was to reduce our dependence on imported oil through the use of substitute fuels, such as coal. During this period various incentives were enacted to encourage the production and use of coal and to a large degree these incentives have met with success. The inclusion of mining exploration and development expenses as a tax preference will have just the opposite effect. In addition, it will penalize firms that have already invested funds in this area and made plans based on well-established national objectives.

(3) Deductions for debt to carry tax-exempt securities -This item would include interest on indebtedness to purchase or carry tax-exept securities, to the extent this interest is deducted under current law. In determining the amount of the interest deduction to be added to the minimum tax base, the corporation's total interest deductions will be allocated pro rata across its total investment portfolio.

Effect: This provision would have its greatest impact on the banking industry, since the normal rule under Code Section 265 disallowing the deduction of expenses and interest relating to tax exempt income does not apply to commercial banks or other financial institutions that have less than 15% of their total assets invested in tax-exempt securities. Some banks have already estimated there will be sharp increases in their taxes if the new alternative minimum tax plan is approved. The Treasury's own estimates indicate that the tax on the banking industry as a whole would be increased by approximately 50% from its current level.

In addition, this provision is directly contrary to a long-established policy of providing assistance to state and local governments and other tax exempt entities with their financing. The provision will force states and localities to offer higher interest rates in order to compete with others for funds and will further depress an already depressed tax-exempt bond market.

(4) Deferred DISC income - This item would include a corporate shareholder's pro rata share of DISC income for the year that is not taxed currently.

Effect: The DISC provisions were originally enacted to encourage exports and to enable us to compete more effectively in the European common market. The provisions will have an adverse effect on these objectives and are contrary to arguments advanced by the U.S. Treasury in the latest trade and tariff negotiations with European common market countries.

(5) Amortization of motor carrier operating rights - This item would include all deductions claimed under the five-year amortization provisions added by the Economic Recovery Tax Act of 1981 for motor carrier operating authorities which diminished in value as a result of the deregulation of motor carriers on July 1, 1980.

Effect: The Motor Carriers Act of 1980 deregulating the motor carrier industry virtually eliminated the value of operating rights owned by the carriers. Consequently, many carriers which had made substantial investments in operating rights were suddenly faced with a nearly total loss on their investments. Congress recognized this hardship in the legislative history of the Motor Carrier Act and stated that deregulation might require further consideration of relief for the diminution in value of these rights. These conclusions were reaffirmed when such relief was provided as part of ERTA. We are not aware of any change in perceived need for such relief.

(6) Excess OID interest - This item would include interest deductible on original issue discount (OID) bonds in excess of the amount that would be deductible were the original issue discount amortized according to a method which yields the same pattern of deductions that would result from borrowing the same amount of money with par-value bonds having the same yield to maturity.

Effect: The presently outstanding debt issues which would be affected by this provision were priced and offerred at a time when the tax rules did not include a taint on the excess OID interest. Retroactive application of this rule is not appropriate.

MODIFIED COINSURANCE

Current Law

The Life Insurance Company Income Tax Act of 1959 was enacted to provide Treasury with an appropriate level of tax revenue from the life insurance industry. Thus, it was anticipated that the industry would be paying its "fair share" of the total corporate income tax--essentially a legislative judgment. At the same time, the Act was designed so that the total tax burden would be apportioned in an equitable manner between the two major segements of the industry -- the mutual companies and the stock companies -- while also providing features to benefit small and new life insurance companies.

Substantial changes in the economy, as well as in the life insurance industry, have occurred since 1959. The high rate of inflation in recent years together with concomitant high interest rates have had the effect of increasing the effective tax rates of many life insurance companies. Under the 1959 tax formula, the incremental tax rates on additional investment income easily can exceed the 46 percent statutory rate and theoretically can exceed 100 percent. According to one industry report, the share of total corporate tax paid by the life insurance industry rose from about 2-1/2 percent of total corporate tax in 1960 to about four percent of total corporate tax in 1975. During this same period pension business has become increasingly important to the life insurance industry and new products that did not exist in 1959 have been introduced. These include individual retirement accounts, universal life products, indeterminate premium products, variable life insurance, and single premium deferred annuities. The tax treatment accorded these products is uncertain and may be inequitable.

For these reasons, there is a question as to whether the life insurance industry is paying more or less than its fair share of the corporate income tax. Also, it is difficult to determine whether there is a reasonable apportionment of the tax burden between the mutual and stock companies, so that neither group is able to obtain a competitive advantage solely because of the impact of the federal income tax. Similarly, it is unclear whether the tax is fair insofar as small and new life insurance companies are concerned. The income taxation system should be as neutral as possible as far as competition within the industry is concerned.

Equitable taxation of the life insurance industry involves, as it did in 1959, some very complex issues. There is the long-term nature of many of the products which makes it difficult to determine a proper tax base on an annual basis. The makeup of the industry itself, mutual and stock companies, large and small companies, old and new companies, and companies specializing in certain products makes equitable taxation difficult. In addition, life insurance companies have to compete with other financial institutions for savings' dollars. The resolution of these complex issues requires detailed study which will involve a considerable amount of time.

Proposed Changes

The Administration proposes that Section 820 be repealed. Section 820 provides special rules to govern the tax treatment of modified coinsurance contracts if both parties consent to the specified treatment.

In addition, the Administration proposes to amend Sections 804 and 809 to clarify the treatment of experience refunds.

Ernst & Whinney Comments

The Administration proposals to repeal Section 820 dealing with the optional treatment of modified coinsurance contracts and to clarify the treatment of experience refunds should not be considered in isolation from the other aspects of taxation of life insurance companies. These proposals, in isolation, do not consider whether the industry will be paying its fair share of the corporate income tax and whether there will be tax neutrality among the various segments of the life insurance industry and with other financial institutions.

We also believe that prevention of a double tax is still a valid purpose of Section 820. As stated in the Committee Reports on the 1959 Act, "it is possible for the same income to be taxed twice - once to the initial insurer as investment income and a second time to the reinsurer as underwriting gain." An illustration of this double taxation is attached as Exhibit B.

Because of all of these factors, we do not believe that the Administration proposals with respect to taxation of life insurance companies should be adopted. Rather, temporary measures should be developed which are equitable to the industry, provide for an adequate level of tax from the industry, and preserve the opportunity for economic balance within the industry. This should be followed by an all-out effort by Treasury, the Congress, and the life insurance industry itself to study the required changes to Subchapter L that will result in fair and equitable taxation of the life insurance industry in today's environment.

EXHIBIT B

Modified Coinsurance Example

Before reinsurance, assume the following facts with respect to a block of life insurance business owned by a mutual life insurance company. Assume that the mutual company's tax base includes only investment income (a Phase I company) and the tax rate is 50%.

Premiums received from policyholders	$1,000,000
Investment income earned	80,000
Reserves established	(750,000)
Claims and expenses paid	(250,000)
Profit before income tax	$ 80,000
Income tax	(40,000)
After-tax profit	$ 40,000

Assume that the mutual company reinsures this business on a modified coinsurance basis with a stock company whose tax base includes both investment income and underwriting income (Phase II negative company). The results, without Section 820, are as follows:

	Ceding Company	Assuming Company
Premiums received from policyholders	$1,000,000	$ -0-
Reinsurance premium	(1,000,000)	1,000,000
Return of reserves under modified coinsurance contract	750,000	(750,000)
Payment of investment income related to reserves	(60,000)	60,000
Tax reimbursement	30,000	(30,000)
Net premium income	$ 720,000	$ 280,000
Investment income earned	60,000	20,000
Claims and expenses paid	(250,000)	
Reimbursement of claims and expenses paid	250,000	(250,000)
Reserves established	(750,000)	
Profit before income tax	$ 30,000	$ 50,000
Income tax	(30,000)	(25,000)
After-tax profit	$ -0-	$ 25,000

The result is that the $60,000 of investment income earned by the mutual company with respect to the $750,000 in reserves returned is taxed as investment income to the ceding company and again is taxed as premium income to the assuming company. The total tax for the two companies is $55,000 with reinsurance and only $40,000 without reinsurance.

If an election under Section 820 is made, the results are as follows:

	Ceding Company	Assuming Company
Premium received from policyholder	$1,000,000	$ -0-
Reinsurance premium	(1,000,000)	1,000,000
Net premium income	$ -0-	$1,000,000
Investment income earned	$ 60,000	$ 20,000
Payment of investment income to assuming company	(60,000)	60,000
Net investment income	$ -0-	$ 80,000
Reserves established	$ (750,000)	$ -0-
Reserves transferred	750,000	$ (750,000)
Net reserves established	$ -0-	$ (750,000)
Claims and expenses paid	$ (250,000)	$ -0-
Reimbursement of claims and expenses paid	250,000	(250,000)
Net claims and expenses paid	$ -0-	$ (250,000)
Profit before income tax	$ -0-	$ 80,000
Income tax	-0-	40,000
After-tax profit	$ -0-	$ 40,000

NOTE: No tax reimbursement is required because the assuming company will include the income in its own return.

An election under Section 820 will eliminate the additional tax and leave the assuming company in exactly the same position it would have been in had it written the business itself. This is the same result that would have occurred if the companies had entered into a coinsurance contract rather than a modified coinsurance contract.

STATEMENT OF GERALD W. PADWE, ASSOCIATE NATIONAL DIRECTOR, TAX SERVICES, TOUCHE ROSS & CO., WASHINGTON, D.C.

Mr. PADWE. Senator Dole, thank you.

Good morning. My name is Gerald W. Padwe. I am the associate national director of tax services for Touche Ross & Co.

Obviously, in 5 minutes it is not possible to address in any detail any of the items that we would like to. Our complete statement deals, coincidentally, not only with the three subjects that Herb Lerner has just described, but also with a fourth one which we would invite your attention to, and that is whether the proposals by Treasury to speed up the payment of corporate estimated tax payments really will be effective or cost effective, certainly, given some of the additional burdens on corporations in exchange for the one-time revenue acceleration to Treasury.

I would like to spend the bulk of my time this morning on the completed contract method. It has been in the law for over 60 years, which hardly puts it in the category of a loophole or an abuse, although that is not to say that there are not tightening measures that would be appropriate.

We believe, inasmuch as the proposals before you involve a legislative approach—there are also regulatory proposals which do not require congressional approval—we believe that whatever tightening is necessary—and there is some—can be accomplished through regulation as opposed to legislation. In fact, we are very concerned about the legislative proposals that have been presented to you on this subject.

First of all, they do not repeal only the completed contract method for long-term contractors. They would also repeal the cash method and the accrual method of accounting for tax purposes. And this will affect primarily the smaller contractors. Very few large contractors use either the cash or accrual method. A great many small contractors do, but under the Treasury proposals they would also have to use the progress payment or percentage of completion method.

The legislative proposal also prohibits a current deduction for certain costs such as interest and general administrative costs, which are presently available for tax purposes under the law today. In fact, these proposals would put contractors on a worse footing with respect to such costs than noncontractors.

Even manufacturers who are subject to very stringent full absorption costing rules under present Treasury regulations are still entitled to deduct immediately, as period costs, interest and the bulk of general and administrative expenses. Contractors would not even have that option open to them.

We would also like you to consider, with respect to the economics of this proposal, who is going to pay the price. The greater part of these changes will certainly increase or accelerate taxes for two major industries: the defense/aerospace industry and the construction industry. The result of raising their taxes, and it is a true raise—it is an acceleration, technically, but even use of money from accelerating tax payments produces true incremental costs—the result of raising these costs is that these industries must either accept lower profit margins or pass them on to their customers. And I think when you start looking at who are the customers of the industries that you begin to raise your eyebrows a bit.

For example, one major customer of the aerospace and defense industry is something called the U.S. Government. Consequently, we will find Treasury putting revenues into one pocket and then pulling them out of another pocket in added procurement costs.

The civil aviation industry is certainly one that is going to feel the additional costs being passed on as they try and modernize their aircraft fleets. Most airlines today are in serious financial difficulty. Is this a segment of the economy that should be further burdened financially?

With respect to the construction industry, urban dwellings, apartment buildings, condominium buildings, et cetera, will feel these increased costs and have to pass them on to city dwellers.

So we think that the proposals are somewhat misdirected, they have structural defects, and they should be thought through somewhat further. We also believe that what changes are appropriate to be made can and should be made by regulation.

Thank you very much.

[The prepared statement follows:]

Touche Ross & Co.

SENATE FINANCE COMMITTEE

HEARINGS ON ADMINISTRATION TAX PROPOSALS

STATEMENT BY GERALD W. PADWE
ASSOCIATE NATIONAL DIRECTOR - TAX SERVICES
TOUCHE ROSS & CO.
MARCH 18, 1982

Mr. Chairman, and members of the committee:

My name is Gerald W. Padwe, and I am Associate National Director - Tax Services for the international public accounting firm of Touche Ross & Co. It is a privilege and a pleasure for me to represent my firm before you this morning, and to present our thoughts with respect to particular aspects of the 1982 tax changes being proposed by the Administration. Touche Ross is a major international public accounting firm, with an extremely diverse tax practice. As practioners, and tax consultants to a wide range of industries and types of business entity, and with a practice encompassing both the largest companies and the smallest businesses, we are certainly interested in both the policy and technical ramifications of major tax legislation.

We are deeply sympathetic to the problems faced by this committee, the rest of the Congress, and the Administration in attempting to cope with an apparently non-responsive economy, and to limit the amount of projected deficits for the next fiscal years.

To that end, our comments on Treasury's proposal will deal with only a few areas, in which we believe there are structural deficiencies or where the results anticipated by Treasury will not, in our judgment, be accomplished.

Accordingly, we would like you to consider our thoughts on the following subjects:

1. Modification or repeal of the completed contract method of accounting.
2. Acceleration of corporate estimated tax payments.
3. Statutory repeal of tax benefits from modified coinsurance.
4. International ramifications of the proposed corporate alternative minimum tax.

Modification or Repeal of Completed Contract Method

As one of the more important "loopholes" sought to be closed by the Administration tax proposals, the completed contract method of accounting - for the reporting of income on long-term contracts - has come in for particular attention; with plans to repeal the method and dramatically change tax reporting in this area, by both legislation and regulation. While we believe there is definite room for tightening the completed contract rules, and that such tightening would produce an acceleration of tax revenues, we have great concern that the proposal for total repeal - not to mention placing long-term contractors on a substantially worse tax footing than other businesses with respect to period costs - is ill advised. We are not convinced the economic impact of the proposals has been completely thought through and we believe that the alternatives - regulatory and legislative - will have far reaching results rather different from those being suggested by Treasury.

The completed contract method, even if looked at today as a "loophole", is hardly a new concept in the Internal Revenue Code. For construction contractors, it has been a recognized method of tax reporting since 1918; for manufacturers, the method has been permitted since 1971, and that change for manufacturers was based upon negotiations with the Treasury Department at that time. Interestingly, one of the reasons for permitting completed contract for manufacturers was the perceived difficulty by IRS agents and Appellate conferees of agreeing on estimates of completion in the then commonly used percentage of completion method. Yet, under Treasury's present proposals, the percentage of completion method is one of only two which will be permitted contractors. We think it appropriate to ask why, given a 64-year history of acceptable tax reporting under the completed contract method, the entire method is suddenly seen as a loophole or an abuse, to be repealed entirely.

Turning to the rationale for eliminating this method of tax reporting for contractors, we would like to challenge one argument, in particular, as somewhat disingenuous; especially given the fact that we are engaged in the practice of accounting. The Treasury General Explanation on "Reasons for Change" points out:

> "The completed contract method permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices." (emphasis supplied)

That statement, while correct, is not the whole story. For example, we wonder whether Treasury would, as enthusiastically, support an acceleration in the timing of certain deductions in the Internal Revenue Code, on the ground that present tax practice defers the deduction until long after the expense is claimed according to standard accounting practice. We suspect not, and ask you to recall that as recently as 1979, the Internal Revenue Service was upheld by the U.S. Supreme Court (in the Thor Power Tool case) in denying taxpayers a deduction for certain excess inventory costs on the grounds (among others) that generally accepted accounting principles were irrelevant in the face of Treasury regulations taking a different view.

We believe the analogy not misplaced. If financial reporting practices have little or no bearing on the deduction side of the ledger, we would suggest the same is true in terms of using such an argument for support on the revenue side.

As to the substance of the Administration proposals, we do recognize some of the concerns sought to be addressed, and agree they can be dealt with by regulatory change. Clearly, the regulations presently in place did not contemplate the ability of contractors to maintain a contract in an incomplete status for 10 or 20 years. To the extent that this result is supported by artificial means, it is appropriate to seek change in regulation, though we do not see the need for legislative action. The treatment of indirect costs as period costs versus expenses capitalized as part of the contract, is a most difficult one, though one we can also see as being the subject of regulatory proposals (not legislative ones). And, the aggregation and severability issue presents another area for regulatory review and tightening.

We part company with the Administration, however, in the application of and anticipated results from certain aspects of the proposed changes. First, the treatment of period costs - in both the regulatory and legislative proposals - would put contractors in a worse tax position, vis-a-vis such expenses, than any other businesses we can immediately think of. Non-manufacturing taxpayers not using long-term contracts generally write off period costs immediately against income for tax purposes. Manufacturers, on the other hand, are required to allocate a number of period costs to inventory, to be recovered as a cost of sales deduction when the inventory is sold.

To a certain extent, then, there is a parallelism between the treatment of period costs proposed for contractors and that presently used by other manufacturers. But no taxpayers, other than contractors, would be required to allocate interest and all general and administrative expenses to inventory, thus deferring their deduction. These are two major items: in the defense industry, for example, general and administrative expense will generally run from 10-15% of aggregate contract revenues. Non-contractors (even manufacturers) can deduct all or most of these costs directly; why such draconian rules are needed for contractors is a case we do not believe the Administration has yet made.

Aside from the conceptual question of why manufacturing contractors are to be treated worse than their non-contracting peers with respect to such important items as discussed above, we believe the proposal will cause an administrative nightmare. In the defense industry, where a manufacturer may have 20 or 25 projects in process at one time, with borrowing levels rising and falling during the course of a year to meet overall cash flow requirements, how the allocation of interest costs among those contracts is to be done, we suspect, will cause a lot of revenue agents and a lot of taxpayers numerous sleepless nights. The allocation of other period costs will undoubtedly cause similar problems.

The above accounting changes with respect to indirect costs are to be accomplished by regulation. We note, however, that a most pervasive change is proposed to be imposed by statute. It provides that, for any long-term contract, the only allowable tax reporting will be the progress payment or percentage of completion method. In other words, taxpayers will no longer be able to use the accrual method or the cash method of accounting for long-term contracts, even though they have been entitled to do so in the past. This is a matter of real concern, particularly as applied to smaller contractors. For ease of record keeping, many of them use the cash or accrual basis whereas, on the other hand, very few contractors with substantial revenues (more than a few million dollars) use the cash or accrual method. Outlawing these traditional methods of tax accounting is not only harsh, but will have the likely effect of harming, primarily, smaller businesses.

At this point, we turn to the progress payment and percentage of completion proposals. In our view, neither will accomplish, completely, its intended effect, largely because we believe each will be used by a different important segment of the taxpayer class at which the changes are directed.

First, turning to the progress payment method, those electing its use will have to determine profitability on a contract-by-contract basis. Contracts where the right to receive progress payments in a year exceeds costs allocable to that contract will produce taxable income reportable in the year. Contracts, on the other hand, having costs incurred in excess of a right to receive progress payments will not be permitted either to reflect a deduction for the excess costs or to offset them against interim profits from other contracts. No contract losses may be recognized for tax purposes until costs incurred on a contract exceed the total payments taxpayer is entitled to at the end of that contract. This "heads I win, tails you lose" approach will undoubtedly persuade taxpayers to utilize the percentage of completion method, where interim losses as well as interim profits are recognizable - at least if they would show interim profits on many of their contracts.

Certainly, we would expect the above argument to be true with respect to the construction industry. Sound business practice in that industry calls for overbilling at the front end of a contract, with the result that most such contractors will likely choose the percentage of completion method over the progress payment method.

Even on profitable contracts, most in the construction industry would find the tax impact of progress payment more burdensome than percentage of completion; where interim losses occur, the use of the progress payment method becomes even more burdensome to a construction contractor.

We have no way of knowing the assumptions on which the Treasury Department based its revenue estimates from repealing the completed contract method, or how each one interacts with the final revenue estimates. However, to the extent those assumptions are based on the use of the progress payment method by the construction industry, we think they are too high. And, according to the Treasury General Explanation, construction industry output represents 35% of annual contractor output in our economy.

With respect to the defense and aerospace industry, where even larger revenue changes are likely to occur, we believe those estimates are also too high, though for a different reason. Unlike construction contractors, defense and aerospace contractors probably will adopt the progress payment method. In their case, current practice - at least in defense contracts - provides for progress payment reimbursement of only 90% of total costs (a few years ago it was only 80%; the 90% figure is actually an improvement over prior practice). Further, as units are delivered under the contract, reimbursement is normally made at an average unit cost - despite the fact that the "learning curve" produces far greater costs per unit at the beginning of a contract than at the end. Thus, defense contracts generally will not provide income recognition, on the progress payment method, until the contract is fairly close to being complete (say, 75%). In other words, legislative repeal of the completed contract method, as opposed to the regulatory changes under consideration, will have very limited impact in accelerating tax revenues for this highly important sector of the U.S. economy. (Treasury estimates defense/aerospace output as 50% of output of the entire contract or class.)

There is another, most important, economic aspect of these proposed changes which we would ask Congress and Treasury to consider most carefully. Whatever change is made - be it repeal of completed contract altogether, modification of the deduction rules for indirect costs, or both - Treasury is certainly correct that the overall effect will be an increase in tax revenues. What we think should be considered somewhat further is who is going to finance that increase.

To begin, it should be noted that the revenues involved represent an acceleration of taxes rather than truly new taxes: the same profit is being subjected to tax, but that tax may no longer be deferred until the contract is completed. Still, (and Treasury has recognized this in their General Explanation of these provisions), even an acceleration of tax revenues produces true incremental costs, arising either from the need for additional financing of the contract or the loss of opportunity cost returns from the deferred taxes. In the example used by Treasury in its General Explanation, a contractor engaged in a five year contract, and having an after-tax borrowing cost of 10%, would produce 15% higher profits were he able to use the completed contract method rather than the progress payment or percentage of completion method, charging the same price.

Thus, contractors would seem to have two choices: reduce profit margins or pass the incremental costs - in whole or in part - to purchasers. If profit margins are reduced, so are Treasury tax revenues. If incremental costs are passed on to customers, one of the most important customers of the defense industry is an entity known as the U.S. government - which means that Treasury is obtaining increased tax dollars in one pocket, but paying some of them out to those same contractors from another pocket.

There are other important customers for the products of long-term contracts. For example, some of the additional costs would be passed on to the commercial airline industry for the acquisition of new airplanes. Yet, the press reports that too many of these companies are in severe financial straits, and a few seem near bankruptcy. Is this an appropriate segment of the economy for the government to impose additional financial burdens on?

Another economic "beneficiary" of these proposals would be that part of the construction industry engaged in urban residential development. Single-family housing would probably not feel much of en effect, but what of apartment buildings, condominiums, etc.? It seems clear that costs to city dwellers for the rental or purchase of an apartment will, inevitably, have to increase, under the new rules; and again it seems appropriate to ask if that is the part of the economy best able to deal with additional financial burdens.

In short, we believe the full range of effects from repeal and modification of the completed contract method needs to be considered more carefully. There are parts of the proposal that can, indeed, close true "loopholes" in the way the method operates. The method itself, in the tax law for over 60 years, should not be done away with without substantially more study and understanding.

Acceleration of Corporate Estimated Tax Payment

We wish to register our strong disagreement with the Administration's proposal to accelerate corporate estimated tax payments by imposing a penalty for failure to pay in currently 90%, rather than the present required 80%, of estimated taxes during the course of a corporation's current year. In our view, Treasury's perceptions and assumptions with respect to this issue are incorrect. Further, there will be some administrative burden added to the corporate accounting function in exchange for a relatively small return to the U.S. government; and - worse - the proposal represents, essentially, a one-time adjustment, followed by the need for indefinitely continuing the added administrative burdens just to "stay even" with the one-time revenue bump for Treasury.

The Treasury Technical Explanation for this provision presumes "...the ability of corporations to estimate their income on a monthly basis..." This may or may not be accurate for Fortune 100 companies, but it almost certainly is not accurate for medium and smaller size businesses. Even though estimates of financial income may be made monthly, it is no great secret that differences between financial and taxable income can be substantial; and it is undoubtedly a significant minority of corporate taxpayers that routinely prepare monthly taxable income estimates (which would now be required to be accurate within 10%). Just accounting for book-tax differences; adjustments for intercompany transactions where corporations are filing a consolidated return, where adjustments and eliminations are different on a tax basis than on a book basis (or where they file consolidated financial statements but separate returns, and it now becomes necessary to restore the intercompany eliminations and adjustments for tax purposes); the difficulty of obtaining accurate monthly or quarterly information - on a book, much less a tax, basis - where foreign operations are involved; all speak to the practical improbability of arriving at taxable income estimates for each tax quarter that can fall within a 10% range. In fact, given the complexity of today's tax laws, many corporations have difficulty obtaining current information accurate within the presently permitted 20% tolerance, and thus fall back on one of the safe harbor exceptions to avoid penalty. With only a 10% tolerance, and with the trend (at least for large corporations) toward eliminating safe harbor exceptions, an increased number of underpaid taxpayers may be anticipated.

Combined with this is an unusually strong sanction for failure to estimate within the 10% range: a nondeductible penalty charge which, at present, is at a 20% annual rate. For a corporation in the top, 46%, bracket, such a charge is the equivalent of 37% annual interest. In our view, therefore, the medicine is too strong for the illness.

While it may be argued that there is not that much difference in terms of administrative attention required, between an 80% and a 90% test to avoid underpayment penalty, our experience as tax practitioners speaks differently. For individuals, the Internal Revenue

Service will grant an automatic extension of time to file Form 1040, normally due April 15, but only if taxpayer has paid at least 90% of his final tax liability by the time the extension request is filed. If the 90% test is not met, penalties will normally be asserted for late payment of tax.

Our experience has been that the need to compute final liability within a 10% tolerance is often so difficult that it requires as much work to obtain the extension as to file the actual Form 1040. Clearly, a 20% margin for error would give substantially more than twice the confidence level that tax would not be underpaid than would a 10% margin - and in our situation, we are talking about meeting the 90% test 3½ months after the year closes. Imagine a corporation trying to make such determination, within 10%, by the middle of the fourth month of the current year, with 7½ months still to go before the year closes.

Thus, if the proposal is enacted, it strikes us the likely result will be the need for providing still tighter accounting controls than presently exist, enabling corporations to currently extract, on a more accurate basis, the type of information required to avoid the penalty. For many companies with internal tax staffs, this will mean additional hours spent (at additional corporate cost) to obtain this information. For those companies without their own tax staffs (and that is certainly the large majority of corporate taxpayers), it will undoubtedly be necessary to increase legal or accounting fees for outside help in this area. Even so, with only a 10% tolerance as opposed to the present 20%, many more taxpayers will underpay and be subject to the penalties involved. For an Administration that has promised to get government off the backs of the American people, this proposal is hardly a step in that direction.

What we find particularly unfortunate about it is that, while it certainly will increase the timing of cash flow to government, the timing represents, basically, a one-time benefit to Treasury: after the first year, in which there is a true cash flow speed-up, the same administrative procedures must be carried out annually forever in order just to stay even with the first year's acceleration. Thus, except for rising tax liabilities, the cash flow improvement only helps Treasury once.

We note that the revenue estimates prepared by Treasury provide an additional $4 billion during fiscal 1983-1985. Thereafter, the next two years produce a net zero revenue flow and, in fact, by fiscal 1987 there is actually a small net loss to Treasury. It would be interesting to know, in these numbers, how much of the estimated additional revenue comes from underpayment penalties, rather than true acceleration of cash payments. We would expect those penalties to increase to some degree and, if there is any agreement on that score, it would seem inappropriate to impose a tax provision that could be extremely difficult for taxpayers to comply with, but would then result in producing additional revenues to government through penalties for noncompliance.

Repeal of Modified Coinsurance Provisions

We would strongly urge the Congress, despite the attractiveness of revenue gains from repealing the ability of life insurance companies to use modified coinsurance (Modco) in reducing their taxes, not to enact such repeal at this time. In brief, life insurance taxation is one of the most complex areas of the Internal Revenue Code. The present system for taxing life companies has been in place since 1959, and section 820 (the section sought to be repealed) is but one of many special provisions which treat life insurance companies as different from casualty insurance companies, and vastly different from non-insurance corporations.

Even if the 1959 system is obsolete or badly in need of overhaul (an issue we do not here address), we believe taking only one part of that system and eliminating it for revenue raising purposes is to deal with a symptom only. The proper approach is a complete review of the tax system as it applies to life insurance companies, and a bringing of that entire system up to date.

Treasury's General Explanation of this provision states:

> "The modified coinsurance provision of the Code was never intended to produce large tax benefits for insurance companies. The Federal corporate income tax paid by the largest mutual life insurance companies fell by 35 percent from 1979 to 1980, and by more than 40 percent from 1980 to 1981. The primary reason for this reduction is modified coinsurance."

Our concern with the above quotation is that, while in no way challenging its accuracy, it presents only one side of a much more complicated story. We feel it appropriate to ask why mutual life companies have felt it necessary to reduce their tax burdens through Modco, before deciding that such reduction is unwarranted. And, in very simplified form, one answer is that the operation of another part of life insurance tax rules has so increased the tax burden on these companies, in a manner not foreseen when the rules were put in place in 1959, that prudent planning to protect reserves needed for future insurance claims has been directed to other ways of decreasing taxes.

Life insurance company investment income is subject to tax at top corporate rates; i.e., a 46% maximum. In determining taxable investment income, a reserve interest deduction is permitted, calculated mechanically on the so-called "10 for 1" formula. The formula contrasts the actual investment earnings rate with an assumed reserve rate, and the difference between the two is used in arriving at a reserve adjustment factor which, in turn, becomes an important point in calculating the reserve interest deduction (the formula is called the "10 for 1" formula, because each one percentage point increase in the rate of actual investment earnings requires a 10 percentage point decrease in applying the reserve adjustment factor).

Traditionally, the assumed reserve rate for the industry has been around 3%, and part of the reason for it being so low involves ceilings imposed by State statutes. However, using the 3% assumed reserve level, the 10 for 1 formula results in the reserve interest deduction being computed along a parabolic curve on which the interest deduction increases, along with actual investment earnings, until the actual earned rate is 6.5%; thereafter, continuing along the curve, although the actual rate and actual earnings continue to increase, the deduction decreases - absolutely, not just proportionately - with the effect that each additional dollar of gross investment income produces more than $1 of taxable income. Thus, the marginal rate of federal income tax on investment earnings will go beyond the statutory rate when the life insurance company's actual investment earnings rate gets to 7%. If that rate gets to 13%, no deduction at all is allowed for reserve interest, and the marginal rate on investment earnings will be close to 100% (under certain circumstances, it will exceed 100%).

With that background, let us look at the situation today. The current, industry-wide, actual investment earnings rate was 7.00% in 1977, 7.39% in 1978, 7.78% in 1979, and 8.06% in 1980. Thus, for the past four years, but for taking other actions, life companies would have incurred marginal tax rates on investment income in excess of 46%. The current Administration, and many in Congress, argue that businesses and individuals make investment decisions on the margin, and marginal tax rates are extremely important. Perhaps, attempts by mutual life companies to reduce marginal rates on investment income (through modified coinsurance, for example) is just an early recognition that supply side economics is not new to business.

It should be noted that, no matter how high investment earnings rates go, the mechanics of the reserve interest deduction formula assure that the effective tax rate on investment income will not exceed 46%, even though the marginal rate may be at around 100% where the actual earnings rate is 13%. Still, we do not believe that is a sufficient answer to the above points on marginal rates. For example, in 1959, and for a few years thereafter, the actual earnings rate on investment income was around 3 to 4% rather than the 8% of today. Because of the 10 for 1 leverage in the formula, a 3% actual rate contrasted with the 3% assumed rate would produce an effective tax rate on investment earnings of a little over 4%. A 4% actual earnings rate would increase the marginal rate to about 24%, but the effective rate would still be just over 9%. Contrast this with today's situation, where an 8% actual earnings rate produces approximately a 53% marginal tax rate on those earnings, and an effective tax rate of about 26%. If the actual earned rate were ever to get to 12%, the marginal tax rate would be around 83% and the effective tax rate about 41%.

Obviously, it is correct that higher actual earnings rates produce higher investment earnings. Still, the significantly greater percentage of those earnings going to federal income taxes causes management to seek ways of otherwise reducing the tax burden, such as Modco.

We are not arguing that the present tax treatment of modified coinsurance, per se, is good or that it must be maintained. But, we are pointing out that Modco is a symptom of a much larger problem: the need to readdress the viability of the 1959 Life Insurance Tax Act as it meets the needs of government and the industry in today's economic climate. We are aware that the insurance industry has put a proposal before Treasury, and is trying to negotiate a stop-gap measure with them. Without, in any way, taking sides on that proposal, or as to what the tax rules applicable to life companies should ultimately be, we do feel it important that Congress not deal only with one particular aspect of what should be recognized as a highly complex problem.

Alternative Minimum Tax for Corporations

The Administration has presented an alternative minimum tax proposal to Congress, and others (including the Chairman of your committee) have also expressed interest in the concept. We recognize the interest of both branches of government in reducing deficits by all prudent means, and are aware that those industries which feel particularly the subject of this proposed tax will be heard by your committee.

The points we would like to make, however, are not industry related. In reviewing the Treasury explanation, and becoming aware of possible different approaches to the treatment of the foreign tax credit in a corporate alternative minimum tax system, we believe there are a number of international tax ramifications involved in this entire area. Further, the evolution and complexity of the foreign tax credit rules applicable to the present alternative minimum tax system for individuals, enacted in 1978, makes it clear that this is the most appropriate time to both consider these issues and attempt their early resolution.

To start with the obvious, the minimum tax may have an adverse effect on the flow of capital and business into the United States to the extent the proposed minimum tax would create an additional cost for foreign corporations engaging in business here. We concur, however, that if the U.S. has a significant corporate minimum tax, that tax should fall equally on U.S. business income of U.S. and foreign persons.

The application of the new minimum tax to foreign corporations may, to some extent, be limited by the provisions of U.S. tax treaties. U.S. income tax treaties require the presence of a permanent establishment in the United States before the regular corporate income tax applies to the U.S. business income of a foreign corporation resident in a treaty country. Business income exempt from the regular corporate tax by reason of a treaty should not be subject to the minimum tax the treaty, not preference items, has reduced U.S. tax in these circumstances. This treatment of the minimum tax will be assured if the proposed minimum tax is considered a "covered tax" for purposes of U.S. income tax treaties.

Another question of international significance is how the proposed minimum tax will apply to the foreign operations and income of U.S. corporations. Relevant to this issue is how, if at all, the current and proposed tax preference items relate to foreign activities and foreign income, and whether a foreign tax credit would be available to reduce the proposed minimum tax.

We are pleased that the Administration has proposed allowing the foreign tax credit to be an offset against the minimum tax. It is appropriate for the new alternative minimum tax to allow a foreign tax credit if this new tax is to apply to foreign income.

For over 60 years, the United States has used the foreign tax credit mechanism to avoid international double taxation of foreign income. The objective of avoiding double taxation and the tool of achieving that objective, the foreign tax credit, are just as important to a minimum tax that falls on foreign source income as they are to the regular corporate tax.

Press reports suggest that some may favor making the foreign tax credit a preference item, eliminating it as an offset against the minimum tax, or allowing foreign taxes paid as a deduction against the minimum tax base. We believe it would be unwise to take such action, as failure to grant appropriate parity for foreign taxes might well put affected U.S. taxpayers operating overseas at a competitive disadvantage.

However, controversial as it might appear on the surface, we believe there are arguments to be made (see below) that the corporate alternative minimum tax should not apply at all to foreign source income. And, if the committee eliminated foreign source income from the minimum tax base, then there would be no need for a foreign tax credit against the minimum tax. (As used here, the term foreign source income does not include deferred DISC income. Deferred DISC income usually bears very little foreign tax and, therefore, not allowing a foreign tax credit against a minimum tax on such income would usually not create a hardship. The committee could assure no undue hardship, however, by reducing the amount of deferred DISC income treated as a preference to account for any foreign taxes imposed on such income).

There are several reasons why the committee should consider limiting the minimum tax to U.S. source income. Most of the current and proposed preference items relate principally, if not solely, to U.S. activities and income. Two preferences that are likely to be relevant to U.S. tax on foreign source income -- percentage depletion on minerals other than oil and gas, and capital gains -- have already been focused on to some extent through adjustments in the foreign tax credit limitation (Sections 901(e) and 904(b)). And, many U.S. corporate taxpayers are paying more foreign taxes than they can credit against the corporate tax. Thus, the proposed minimum tax may have only a nominal effect on foreign source income of corporations, or affect only select groups of corporations. Second, exempting foreign source income from the minimum tax eliminates the considerable complexity of having special foreign tax credit computations for purposes of the minimum tax. Third, the proposed minimum tax is inherently inequitable, at least in comparing foreign branches and foreign subsidiaries, in that any preferences benefiting U.S. shareholders of foreign subsidiaries by accelerating the deemed-paid foreign tax credit are not -- and without enormous complexity cannot be -- subjected to proposed minimum tax. A U.S. taxpayer operating overseas through a branch may, in contrast, be exposed to the proposed minimum tax to the extent preferences reduced the branch's taxable income. Finally, and most important, the U.S. tax effect of any preferences relevant to foreign income cannot be assessed without examining how the foreign tax credit rules applicable to the corporate tax interact with and are affected by those preferences.

In conclusion, if the committee believes that the U.S. collects too little corporate tax on foreign source income because of a few preferences and the operation of the foreign tax credit, we would suggest that the committee consider holding hearings to discuss how, if at all, the corporate tax should be amended.

The CHAIRMAN. Do you have the list of those appropriate changes that should be made by regulation?

Mr. PADWE. Sir, I will just tell you that they are the types of things such as the treatment of certain period costs. We have listed some of them in our written statement—the treatment of certain period costs, the question of when a contract should be considered complete.

There is no question that today it is possible to have contracts go for 10 years or 20 years in a way that certainly wasn't contemplated by the regulations at any time. The issue of when you have one contract or two contracts, also being dealt with in the proposed regulations, these are quite appropriate for tightening.

The CHAIRMAN. From the accounting viewpoint can the completed contract method be modified so that it would accurately reflect the income of a taxpayer prior to contract completion? There ought to be some way to do that, isn't there?

Mr. PADWE. One of the problems we have, Senator Dole, is the accounting profession seems to be at least in part here the whipping boy for this particular point. The Treasury explanation points out that one argument for change is the fact that for tax purposes it is possible to defer the recognition of revenues far longer than it is under standard accounting practices. And that is true. The completed contract is allowed for financial reporting purposes, but only in the most limited circumstances. It is almost never used. And percentage of completion is the accepted accounting principle.

On the other hand, I would feel a lot more sanguine about that particular Treasury argument if they would come before your committee and suggest that there are certain deductions that also ought to be accelerated because standard accounting practices require the recognition of those expenses before they are taken for tax purposes.

As the Supreme Court said just a few years ago in the *Thor Power* case, the goals and objectives of financial and tax reporting are so different that possibly they just can't be made to meet completely.

The CHAIRMAN. Mr. Lerner, let me address the minimum tax. You talk about inequities because we have just passed legislation that we would now reverse the utility of some of those incentives. This, you say, would "result in inequities." What about the working men and women who are paying 20, 30, and 40 percent of their income in taxes, who see the wealthy individual or the corporation only being asked to pay 15 percent? Do you think there is any perception problem out there?

Mr. LERNER. For sure there is.

The CHAIRMAN. How would you address it?

Mr. LERNER. Our statement does not challenge the basic concept of an alternative minimum tax but the way it is proposed.

The CHAIRMAN. Do you have a better idea?

Mr. LERNER. Well, I think individually it would be important to address each of the items and make sure that those items that are included in the base for such a tax do not address items for which taxpayers cannot alter prior practices without major disruption; for example, the disposition of substantial holdings in tax-exempt securities or undoing an acquisition involving motor carrier rights—addressing each of the individual items.

The **Chairman**. Do you have some of those suggestions in your written statement?

Mr. **Lerner**. Well, we do not address them in those terms, no. But I would be happy to supplement it along those lines.

The **Chairman**. That would be helpful.

Mr. **Lerner**. Sure.

The **Chairman**. After all, you are in the business. You probably could give us a lot of ideas of how we could pick up $25 or $30 billion in 1983. [Laughter.]

If you have any ideas, we would be happy to accept them right now. What we are looking for is a painless way to pick up about $30 to $35 billion. [Laughter.]

But we haven't found it yet.

Mr. Antes, did you have a statement, or are you here in case they got in trouble?

Mr. **Antes**. The latter.

The **Chairman**. The latter? Well, they didn't get in trouble.

Senator Boren?

[No response.]

The **Chairman**. Senator Byrd.

[No response.]

The **Chairman**. Well, thank you very much. Your entire statements will be made a part of the record. And we would appreciate it if you have some good suggestions. We are not asking you to get into difficulty with your clients, but certainly we can make some changes here. As to the argument that the Defense Department might have to pick up the cost—that may be true, but that doesn't mean we should continue bad tax policy, if it is bad tax policy, does it?

Mr. **Padwe**. If it is a bad tax policy. It has been in the law for 60 years, Senator.

The **Chairman**. Has it been bad policy for 60 years?

Mr. **Padwe**. That is possible, but unlikely.

The **Chairman**. It could be, depending on your point of view.

Thank you.

The **Chairman**. We now have a panel consisting of Mr. Cohen, Ms. Sullivan, and Mr. Bruning.

Do you have an order? Ed, are you first?

STATEMENT OF EDWIN S. COHEN, ESQ., INVESTMENT COMPANY INSTITUTE, WASHINGTON, D.C.

Mr. **Cohen**. I would be happy to go first, Mr. Chairman.

My name is Edwin S. Cohen. I am a partner in the law firm of Covington & Burling, Washington, D.C., and I appear this morning on behalf of the Investment Company Institute.

The institute is the national association of the mutual fund industry. Its membership includes more than 600 open-end investment companies known generally as mutual funds and their investment advisers and principal underwriters.

The institute's mutual fund members have assets of more than $225 billion, and they have approximately 18 million shareholder accounts.

The institute is opposed to the Treasury's proposal for withholding a tax of 5 percent on dividends and interest.

The **Chairman**. Well, I think you don't have to worry about that.

Mr. **Cohen**. Well, I have worried about it, Mr. Chairman, over some 20 years. I sat here in this very seat some 20 years ago when the then-chairman of the committee, Senator Harry Byrd, Sr., had asked various groups to consider this proposal.

The **Chairman**. I don't mean by that we are not going to consider it.

Mr. **Cohen**. Well, in the meantime we have done considerable work on it once again this year. [Laughter.]

In my statement I have indicated some of the information that we have got, which reconfirms the position we had taken before, that that proposal is not feasible and should not be adopted. We, in conference with the Treasury, have given them that information.

I won't take up the time of the committee with an oral statement, in the light of your remark, unless you wish me to do so. But I would say that, while we have not yet had the time to review this in detail with the more than 600 member companies of the institute, we are inclined to believe that the approach in S. 2198, which you introduced last week along with Senators Grassley and Chafee, to require withholding tax of 15 percent on dividends and interest where the payees have not supplied the proper taxpayer identification numbers is a far more promising approach. And we are inclined to think at this point that that would work, that it would be far less expensive, far less burdensome on both payors and payees and in the end produce more revenue for the Treasury.

The **Chairman**. Right. I think the more favorably you are inclined to that position, the more likely we will be able to move to S. 2198 as an alternative. Would that make sense?

Mr. **Cohen**. I think it would, Mr. Chairman.

The **Chairman**. Well, we don't want to lose everything, compliance for interest and dividends need to be improved; that's my only point.

Mr. **Cohen**. We hesitate only because in the time we have not been able to consider it. I, personally, have been an advocate of that move for quite some time, and I think it would be much more effective.

There are some minor suggestions that we would like to review with the staff of the committee, if that would be in order.

The **Chairman**. Certainly.

Thank you, Mr. Cohen.

Ms. Sullivan, it is good to have you back again.

STATEMENT OF MARGARET COX SULLIVAN, PRESIDENT, STOCKHOLDERS OF AMERICA, INC., WASHINGTON, D.C.

Ms. **Sullivan**. Thank you. It is nice to be here.

You have my whole statement there, and I will just give a shorter one, if it is all right with you.

The **Chairman**. Fine.

Ms. SULLIVAN. You know we are grateful that these hearings have been scheduled, and we will limit our remarks to the proposal to withhold 5 percent of the dividend payments from the stockholder for the IRS, because we believe that the facts concerning dividends and interest are not analogous. It would seemingly appear as a very narrow issue, but it could bring about far and wide repercussions, particularly at this time.

We are all aware of our Nation's debt and deficit and the need to cut spending and find added revenue, but this particular proposal would not solve these problems; in fact, it could be a discouragement to risk-taking investment and a disincentive.

We opposed withholding on dividends in the past on this basis, and we have some pretty good evidence to prove we were right.

More and more Americans are becoming stockholders. A survey just released revealed that the number of stockholders increased by 7 percent from June 1980 to June 1981. Over 2 million more people became capitalists. There are now over 32½ million stockholders, and that's the largest number ever.

Of course, that is good news, and it is a definite trend. And we feel it should be nurtured, not restrained. But the most important fact about this survey is its link to the reduction of taxes on capital gains from 48 percent to 28.

After the reduction, new capital raised through public stock offerings rose by $2½ billion for 1978-79. This increase in new capital increased Treasury revenue by $1.8 billion for 1979 and has the potential to create 160,000 new jobs.

The last survey conducted from 1980-81 shows an even greater increase in new capital, an increase of $4.3 billion over 1980. This increased revenue for the Treasury from capital gains by an estimated $2 billion for 1981 and had the potential of creating 250,000 new jobs. In other words, capital left working in the market can generate approximately 50 percent of its dollar value in increased revenue. Capital taken out of circulation by withholding generates zero increase in the revenue base.

It must not be overlooked that these surveys do not even take into account the further reduction of taxes on capital gains to 20 percent as covered in the 1981 Economic Recovery Act. And certainly this should prove an even more attractive incentive for stock investment, given a chance.

Our capitalistic system plays a basic role in our national economy, and it won't work without capital. Our system depends on a continuous supply of new private capital, and to withhold 5 percent on dividends is to withhold capital which should remain productive.

For a country which depends on a capitalistic system it is an enigma why we continue to mistreat capital. We still have a heavy tax on capital gains, we have double tax on dividends, and now this proposal to withhold 5 percent on dividends. This is indicative of a misconception of the vital function of capital, as we know in a free enterprise system, and it diminishes our productivity base.

We are all aware that the main reason for this proposal is based on the belief that a small percentage of income received from dividends goes unreported and untaxed. Of course there are some tax cheaters. We are not up here to defend them. But the vast majority of America's 32 million stockholders are honest taxpayers and should not be kept from full use of their capital to catch the minority.

All corporations that pay dividends are now required by law to report annually to the IRS the amount of dividends paid, name, address, and most importantly, the social security number. Therefore, the IRS already has the information needed to match by computer dividends received to tax forms filed. The answer to the problem of who is and who isn't paying their taxes is built into the system. What it lacks is enforcement. We feel that the solution lies in increasing the enforcement capacity of the IRS, not in punishing all dividend-receiving stockholders to catch the few.

And then there is the feeling of the overpayment of taxes. The Treasury estimates that three-quarters of all tax returns filed reported overpayment. This proposal would only aggravate the problem.

So, actually, what the 5 percent withheld would amount to is an interest-free loan from the stockholders to the Treasury. It gives the Government the right to legally tie up an individual's capital, interest-free, and deprive the individual from being able to invest or reinvest that capital.

Capital must be kept mobile if it is going to generate revenue. It is an accepted fact that anything that helps or hinders the mobility of capital, helps or hinders economic growth.

Certainly, to tie up capital under this proposal would do exactly that—hinder economic growth—and that's not in the best interest of economic recovery. And of course economic recovery is what we all want, isn't it?

Thank you. And thank you for being kind.

The CHAIRMAN. Mr. Bruning?

STATEMENT OF CHARLES A. BRUNING, PRESIDENT, EDGEWOOD BANK, COUNTRYSIDE, ILL.

Mr. BRUNING. Thank you, Mr. Chairman, members of the committee.

My name is Charles A. Bruning. I am president of the Edgewood Bank in Countryside, Ill. I am also chairman of the Community Banking Leaders Council of the American Bankers Association.

Accompanying me is Paul R. Claytor, a member of the taxation committee of the American Bankers Association. He is also the vice president and director of taxes for the American Fletcher National Bank in Indianapolis, Ind.

I would like to thank this committee for the opportunity to testify on behalf of the ABA on the tax proposals contained in the President's budget message.

The need to bring Federal revenues and expenditures closer together is clear. We understand that. However, we think it is important that the impact of certain aspects of the President's tax proposals on individuals and corporations be carefully examined, especially with respect to the financing needs of State and local governments.

The largest single increase in the administration's proposal would come from the alternative minimum tax. The largest share of the increase in banking's tax burden appears to be attributable to the inclusion in the minimum tax base of a portion of total interest expense attributable to the support of tax exempt investments; for example, municipal securities.

You have heard some testimony by now, serious and articulate, about those who are critics of this alternative minimum tax. And we, too, urge you to examine these alternatives very carefully.

We believe that it might prove more constructive and more useful to you to point out the effect of certain aspects of that minimum tax proposal, unless it is abandoned or unless it is modified substantially.

Among the tax preference items listed in the administration's proposal, the item described as "deductions for debt to carry tax exempt securities" is clearly of the greatest concern to our banks. The impact of that item is even more important, perhaps, to State and local governments.

The inclusion of this item in the minimum tax base arbitrarily treats a portion of a bank's cost of funds, our chief cost of doing business, as incurred to purchase or carry all tax exempt securities held by that financial institution. It applies a minimum tax rate to some portion of the bank's interest deduction.

Banks purchase tax-exempt securities for a wide variety of reasons, and I would just like to touch on those briefly.

We usually invest in municipal securities for liquidity; we invest in municipal securities to pledge as collateral for loans; in addition, municipal bonds can be used by commercial banks at the Federal Reserve window as colateral when we borrow.

This committee should consider carefully the impact, in effect, of eliminating at least 40 percent of the market for municipal bonds at their lower-than-taxable yields. Preliminary estimates of the impact this would have on tax-exempt bond markets suggests that it would result in a current increase of about 220 basis points, or 2.2 percent added to the cost of municipal financing today. This increase would come at a particularly tough time for State and local governments. As you know, it has been suggested that those levels of government shoulder more of the burden of various programs.

I think it would probably be less than candid for me not to discuss the impact the tax-exempt bond portfolio of a bank has on the effective rate of income tax calculated as a percentage of total pretax income.

As a percentage of total assets, State and local obligations amounted to only slightly less than 8 percent in 1980 of bank assets, but the effect these assets had on earnings was disproportionately large due to the high operating expenses that we incurred in 1980. The reduction of banking's effective tax rate is not, therefore, attributed to the use of special types of loopholes or tax incentives.

Let me direct your attention to the amount of Federal income tax that commercial banks pay. According to the Treasury Department's statistics for income of 1977, which is the most recent published statistics, banking's share of corporate net income was 2.2 percent. And its share of the corporate tax burden was also 2.2 percent or $1,000,265,000.

Now, I think it would be incorrect and unfortunate for this committee to say that banks pay little or no Federal income tax, despite reporting large profits to their shareholders, as has been put in the Treasury's general explanation. In addition to the taxes paid to the Federal Government by banks, an almost equal amount of revenue is generated by funds that we keep on reserve at the Federal Reserve System. We maintain reserves at the Fed which are noninterest earning to the banks but fact brought into the Treasury annually about $2.4 billion in revenues.

Mr. Chairman, I would like to also say that the ABA is opposed to the administration's proposal to institute a system of withholdings on dividends at source on interest and income. As you know, 2 years ago the Carter administration proposed this same withholding of interest income.

The CHAIRMAN. No; it was a different proposal—significantly different.

Mr. BRUNING. Excuse me. There was a proposal withholding on interest income, and the ABA commissioned a study conducted by the accounting firm of Arthur Young which examined the problems inherent in that. I won't go into them in detail because you have heard some of that testimony.

We have been and will continue to work with the Internal Revenue Service to improve their efficiency on withholding. And with respect to the minimum tax, we urge you to consider it carefully as to the impact on State and local governments.

I thank you.

The CHAIRMAN. Thank you very much, Mr. Bruning.

[The prepared statements of the previous panel follow:]

STATEMENT OF EDWIN S. COHEN ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE BEFORE THE SENATE COMMITTEE ON FINANCE CONCERNING THE PROPOSAL TO WITHHOLD TAX ON DIVIDENDS AND INTEREST

March 18, 1982

My name is Edwin S. Cohen. I am a member of the law firm of Covington & Burling, Washington, D.C., and I am of counsel to the Investment Company Institute, on whose behalf I appear today.

The Institute is the national association of the mutual fund industry. Its membership includes more than 600 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. The Institute's mutual fund members have assets of more than $225 billion, and have approximately 18 million shareholder accounts.

Mutual funds are designed to permit thousands of investors to pool their resources as shareholders in a fund which in turn invests in a large number of stocks or debt instruments under the supervision of a professional investment adviser. Mutual funds provide an economical way by which investors can obtain professional advice and diversification of investments. The shareholders of the fund are the owners and are entitled to all of the fund's net income, which consists of the dividends, interest and net capital gains generated by the fund's investment, less the fund's operating expenses, such as investment advisory, custodial and accounting fees.

The mutual fund industry has always been most anxious to assist in the improvement of the operation of the internal revenue system. In particular, some twenty years ago, when a proposal for withholding of tax on dividends and interest was under consideration in the Congress, the Investment Company Institute spent considerable time studying various methods of withholding to determine the method that was most feasible. In the course of this work, we came to the conclusion that the proposal then made, even after it had been substantially revised, was not feasible and that it would impose an unreasonable burden, especially upon lower middle and middle income shareholders of the funds. The Institute did recommend a number of measures to improve compliance, including the institution of greatly expanded reporting by payors on Form 1099, and its members have endeavored to cooperate with the I.R.S. in its administration of the program.

Again in 1980, when a similar withholding proposal was made to the Congress, we gave the most serious attention to its feasibility and once again came to the conclusion that it should not be enacted, but that other measures and remedies were preferable. Reluctantly, we come to the same conclusion with respect to the Administration's present proposal, which is similar to the 1980 plan except that it would withhold from dividends and interest 5 percent instead of 15 percent.

However, although we have not yet had the opportunity to explore it fully since its introduction on March 11, 1982, the Institute believes that the provisions of S. 2198 for withholding 15 percent tax when taxpayer identification numbers are not furnished by payees is likely to prove more feasible and to be more efficient, with substantially less expense and paperwork.

Inherent Dilemmas in Proposals for Withholding Tax on Interest and Dividends

Withholding tax on dividends and interest involves an inherent difficulty that is not found in withholding on wages and salaries. In wage and salary withholding the amount of income tax to be withheld by the employer varies with the marital status of the employee, with the number of personal exemptions of the employee and with certain other factors related to his own personal situation. The amount of tax withheld is graduated on a rate schedule designed to approximate the tax that will actually be due on the employee's final return. This is feasible with respect to wages and salaries because most individuals work for only one employer, from which they receive frequent payments of compensation, and have a direct personal contact with the employer on the business premises where they work. When the employee's marital status changes he or she notifies the employer readily by personal contact, and the percentage of tax withheld varies automatically according to withholding tables as the employee's periodic compensation increases or decreases. Thus withholding on wages and salaries is tailored in general to the final tax liability of the employee.

This system of withholding is not feasible with respect to dividends and interest for a number of reasons. Persons who receive dividends and interest frequently derive the income from a variety of different sources. Their contact with the payors often exists only through the mails, and they often must deal with a distant computer. Their stocks and bonds are frequently registered in the names of banks, brokers or other agents, and they frequently shift investments. There is no feasible way to correlate the amount of tax to be withheld with the amount of tax that the payees will ultimately owe. Thus every withholding system for interest and dividends that has ever been considered has involved a flat rate of withholding, although the ultimate tax owed by the payee is based on a graduated tax schedule after allowance for various deductions.

But withholding a flat rate of tax on dividends and interest involves a dilemma in choosing between (1) administrative feasibility and simplicity for payors, payees and the I.R.S., and (2) fairness to those payees who owe no tax or owe substantially less than the amount withheld. Elemental fairness requires some means for exempting from withholding payments made to charities, universities and other exempt organizations, the elderly, children, pension trusts and others who owe little or no tax. Moreover, there is no point in having persons withhold tax on payments made to banks, mutual funds, insurance companies, corporations, brokers and the like, who as payees are better equipped to pay the proper tax than are many of the payors to withhold the tax and pay it over to the I.R.S.

Thus in designing a system of dividend and interest withholding, one is forced to the conclusion that many payees should be permitted to file exemption certificates with payors, so that payors will either (1) withhold a flat percentage of the dividend and interest payment or (2) withhold nothing. In that event some written statement must be given by the payor to each payee to attach to his or her tax return to show whether or not tax was withheld on the payment. The procedures for handling of exemption certificates, in the myriads of cases in which they would be permitted, involve enormous administrative problems and expense and inevitable errors, particularly since so many exemption certificates will move by mail without the personal contact between payor and payee that exists with respect to wages and salaries.

A second dilemma exists in fixing the flat rate of withholding. If the rate is high, there will be extensive overwithholding, forcing payees to wait until they have filed their tax returns after the close of the year and have obtained a refund from I.R.S. If the rate is low, it will capture little of the tax actually due from payees, and the expense and difficulties of administering the withholding system will be large in relation to the I.R.S. receipts from the withholding.

In 1961 and 1962 the Treasury proposed withholding of 20 percent, and in 1980 it proposed 15 percent. Both of those proposals were shown to involve extensive overwithholding. In an attempt to reduce the amount of overwithholding, the Treasury now proposes a low withholding rate of 5 percent. The lower rate would reduce, but would not eliminate, the overwithholding. Naturally it is estimated to produce less revenue, but the cost and paperwork, both for payors and payees, of instituting and operating the system would be the same and would be much higher in relation to any revenue gain.

Under a withholding system involving only a 5 percent rate, the I.R.S. would naturally have to pursue, as it now must do, all those who owe tax of more than 5 percent. In 1983 the individual income tax rates will run from a bottom rate of 11 percent to a top rate of 50 percent. Thus for any payee receiving dividends and interest who is otherwise subject to tax, the 5 percent withholding on dividends and interest would be less than half of the lowest tax rate and only one-tenth of the top bracket rate. Withholding at 5 percent would be an inadequate tool to deal with intentional or unintentional omission of dividend and interest income from an income tax return. Obviously the I.R.S. would have to pursue other remedies, and if additional statutory authority is needed by the I.R.S., 5 percent withholding will not suffice.

Overwithholding

Lowering the withholding rate to 5 percent, as now proposed, will, as noted above, reduce the number of cases in which excessive amounts will be withheld by payors but will not eliminate the problem. The lower withholding rate, together with permission for persons over 65 to claim exemption from withholding if their tax liability for the previous and current year is below $500 ($1,000 on a joint return), would substantially eliminate overwithholding for those over 65. But for persons under 65 whose income is derived from dividends and interest, overwithholding would occur in a significant number of cases because those persons could not claim exemption from withholding if they have any federal income tax liability whatsoever in the previous or current year. For example--

> A married couple, retired at age 63, with interest and dividend income of $5,601 in 1983, who have no other income except from social security and who do not itemize deductions, would-

Have tax withheld of	$280.05
But would owe federal income tax of only	.11
Resulting in excess withholding of	$279.94

The excess withholding of $279.94 would not be returned to them by I.R.S. until after they file their 1983 tax return in 1984, and the refund would bear no interest.

Similar overwithholding would occur with respect to single persons under age 65. In general, overwithholding would occur for married couples under 65 in such situations if their income from dividends and interest ranged between $5,601*/ and $9,624, and for single persons under 65 between $3,401*/ and $5,739. The extent of the overwithholding in years beyond 1983 would depend upon the income tax rates then in effect and would increase when the exclusion of up to $450 per person from interest income under section 128 of the Code becomes effective in 1985.

Administrative Burden

The Institute estimates that there would be approximately 400 million different dividend and interest bearing investments held by investors that would require withholding or processing of exemption certificates under the Treasury's proposal.**/ The proposal would represent a significant paperwork increase over present law. Not only would there be an increase of twenty-five percent in the number of dividend and interest bearing investments subject to reporting on Form 1099, but, unlike present law, taxpayers would be required to attach the Forms 1099 to their tax returns.

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*/ Below these amounts the individuals would be entitled to claim exemption from withholding because the combination of personal exemptions, the $100 per person dividend exclusion and the zero bracket amount would leave no tax due. If the income were entirely from interest, the amounts would be somewhat lower. If deductions were itemized, the upper limits for overwithholding would be higher.

**/ This is more than four times the number of employees who are subject to wage and salary withholding, and more than two and a half times the number of Forms W-2 filed with I.R.S. for wage and salary withholding.

The process of withholding from some payees yet not from others, and the preparation and distribution of Forms 1099, would entail a heavy and costly administrative burden. Individuals would not be able to claim credit for the tax withheld unless they attached all required Forms 1099 to their returns. Thus, it would be necessary for payors to supply replacement copies for Forms 1099 that are lost during mailing or otherwise. Clerical errors would be inevitable. Replacement and correction of Forms 1099 would require costly individual correspondence and handling.

The administrative burden of the proposal would be intensified by the need to process exemption certificates. The number of investors who would be entitled to file exemption certificates would be large indeed, including the following:

1. All individuals under age 65 who had no tax to pay in the prior year and expect to pay none in the current year.
2. All married individuals over 65 owing less than $1,000 tax in the prior year and expecting to pay less than $1,000 tax in the current year, and single persons over 65 owing less than $500 tax.

3. All tax-exempt organizations, including charities, colleges, foundations, pension and profit-sharing trusts, individual retirement accounts, etc.

4. All corporations.

5. All banks, brokers, securities dealers and certain other nominees who hold investments in their names for the benefit of their customers.

The Institute estimates that approximately 40 percent[*] of the 17.9 million shareholder accounts in mutual funds would be entitled to file exemption certificates. This would mean that in the mutual fund industry alone some 7 million exemption certificates could be filed by payees and have to be processed and administered by the payors. We believe that, especially since most of these exemption certificates would have to be communicated through the mails without personal contact, the administrative burden upon the mutual fund industry and its shareholders would be onerous indeed, not only in instituting the system but also in maintaining it as shareholders enter and leave the mutual funds and their entitlement to exemption changes.

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[*] Our data indicates that some 3.3 million shareholder accounts in mutual funds are so-called "institutional accounts," owned by pension and profit-sharing plans, charities, corporations, other financial institutions, etc., which would be entitled to exemption from withholding. In addition, with respect to the remaining 14.6 million accounts owned by individuals, surveys indicate 37 percent are over 65 years of age, and the Treasury's General Explanation of its withholding proposal estimates that 70 percent of persons over age 65 would be entitled to claim exemption from withholding. This would indicate that about 3.8 million elderly mutual fund shareholders would be entitled to claim exemptions. The aggregate of the institutional accounts and the exempt elderly accounts would be more than 7 million accounts out of the aggregate of 17.9 million that would be entitled to file exemption certificates, or approximately 40 percent. Moreover, children and others below 65 owing no tax would also be entitled to file exemption certificates.

If exemption certificates were not filed and processed by the payors before interest and dividends were paid to these persons, tax would have to be withheld by the payor and the exempt payee would have to await a refund after filing a tax return in the following year. A large proportion of the exemption certificates would have to be sent by payees to payors through the mails, and they could be delayed in transmission or misdirected, without the direct personal contact that readily exists between employer and employee in wage and salary withholding. Mistakes of clerical employees would be certain to occur, creating confusion and resentment of exempt payees whose goodwill is vitally important to the payors.

The filing of exemption certificates would be especially important to retired persons who would otherwise be subject to overwithholding and who would have to claim exemptions promptly. And where stocks, bonds and Treasury obligations are bought, sold and transferred in numerous transactions every business day, the filing and prompt processing of exemption certificates near to interest or dividend payment dates would create a severe clerical burden on the financial industry.

The Treasury estimates that dividend and interest withholding would generate 1.1 billion dollars of revenue in fiscal 1984, exclusive of differences in timing. This revenue estimate must be weighed against the administrative costs of the proposal. The Institute has not been able as yet to make a systematic cost estimate of administering the proposed system. However, it has received estimates from several mutual fund payors that withholding would cost in the range of $1.50-$2.00 per account annually. Per account costs may vary for other mutual funds and for other types of financial institutions. However, given that approximately 400 million dividend and interest bearing investments would be covered, an average annual cost of $1.50 to $2.00 per account would result in a total administrative cost of $600 to $800 million dollars to payors. This would seem to be an excessively high ratio of cost to estimated revenue.

We would note that, according to the 1980 Annual Report of the Commissioner of Internal Revenue*/ and the latest I.R.S. Statistics of Income for 1980,**/ income tax withholding on salaries and wages in 1980 involved about 150 million Forms W-2 that produced some $224 billion in withholding. In contrast, the proposed withholding on dividends and interest, which would be more costly and difficult to operate, would involve some 400 million Forms 1099 that would produce about $7.5 billion in withholding, of which only $1.1 is estimated by the Treasury to result in additional revenue.

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*/ Page 30.

**/ SOI Bulletin, Vol. 1, No. 3, p. 14.

Time of Withholding

The Institute is also concerned that the Treasury's withholding proposals would provide different rules as to time of withholding by various types of financial institutions paying interest and dividends, and these variations would provide competitive differentials in the investment yield to payees. For example, it is provided that depository institutions, such as banks, would not have to withhold until the last day of the calendar year on interest accruing throughout the year. Other competing financial institutions, such as mutual funds, insurance companies, brokers and dealers, would be required to withhold throughout the year as dividends and interest were paid. Under the highly competitive conditions that exist in the financial markets, a difference in the time of withholding would provide an unwarranted advantage to depository institutions in the yields they could make available to investors. We appreciate the desire in the proposals to minimize the cost of administration of withholding by depository institutions, but there would be a comparable need for competing financial institutions and it would be difficult to coordinate the various rules as to time of withholding.

The Proposal in S. 2198 for Withholding in the Absence of the Furnishing of Taxpayer Identification Numbers

The Institute believes that the proposal in S. 2198 (introduced by Senators Dole, Grassley and Chafee) to require 15 percent withholding when payees have not furnished to payors the required taxpayer identification numbers, or when the Commissioner has notified the payor that the number is incorrect, provides a far more promising method of combating underreporting of dividend and interest income than the suggestion for across-the-board withholding of 5 percent from those not filing exemption certificates. While the Institute has not had the opportunity to explore sufficiently with its member companies the provisions of S. 2198 in the brief time since it was introduced March 11, 1982, it believes S. 2198 is likely to be more effective and to involve substantially less administrative expense and burden.

The mutual funds have endeavored diligently to obtain taxpayer account numbers from their stockholders. The Institute's test checks indicate that the proportion of mutual fund shareholder accounts without taxpayer identification numbers is on the order of 3 percent to 4 percent, whereas, as noted earlier, it appears likely that approximately 40 percent of the shareholder accounts would be entitled to file exemption certificates.

It would appear, therefore, that S. 2198 would be far less costly, and that a withholding of 15 percent would likely be far more productive of revenue than a withholding of 5 percent. An increase in penalties for noncompliance, along the lines of S. 2198, would also seem to have a salutory affect.

The Institute would appreciate the opportunity of discussing with the staff of the Committee some possible adjustments of the 15 percent withholding provisions of S. 2198. For example, where a 15 percent withholding is required on receipt by the payor of notice from the I.R.S. that the taxpayer identification number of a payee is incorrect, it may be important to provide for some notice to the payee to insure that there is no mistake in identification and to give the payee an opportunity to correct the error in the number.

We shall endeavor promptly to consult with the member companies about practical suggestions for operation of the 15 percent withholding proposal in S. 2198, but we are inclined to believe that it is more feasible and far preferable to across-the-board 5 percent withholding with a vast number of exemption certificates.

Prepared Statement of Margaret Cox Sullivan, President, Stockholders of America, Inc.

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to appear again before this distinguished Committee on behalf of Stockholders of America, Inc. My name is Margaret Cox Sullivan and I am President of this ten-year-old national, non-profit, non-partisan, membership organization dedicated to representing the interest of stockholders in all publicly held American corporations.

We are grateful the Committee has scheduled these hearings on the tax proposals in the Administration's Budget. We will limit our remarks to the proposal to withold 5% of the dividend payments from the stockholder for the Internal Revenue Service only, because we believe the facts concerning dividends and interest are not analogous. It would seemingly appear as a narrow issue, but it could bring about far and wide repercussions - particularly at this time.

We are all aware of our nation's debt and deficit and the need to search out ways to cut spending and find added revenue but in our opinion this particular proposal would not solve these problems. In fact it could be counter-productive because it would be a disincentive and discouragement to risk taking investment. Investment is imperative to economic growth. We opposed this witholding on dividends on this basis in the past and we have some pretty good evidence to say we were right.

More and more Americans are becoming stockholders. Incentives are the key. A survey just released in December (N.Y. Stock Exchange) revealed that during the 12-month period from June 1980 to June 1981, the number of stockholders who own stock directly, increased by 7%. Over 2 million more people became capitalists and took an active part in our free-enterprise system or people's capitalism. Over 200,000 new stockholders a month put their capital to work. There are now 32.6 million stockholders - the largest number ever - and that's good news. It is a real bright spot and a definite trend.

One of the most important facts about this survey is its link to the reduction in taxes on capital gains which is conceded to be the incentive that attracted this new risk capital - proving incentives are the key. The survey was conducted after the 1978 Revenue Act went into effect which reduced the tax on capital gains from 48% to 28%. Let me give two examples of how the increase in the number of stockholders relates to increased revenue and generates new jobs.

After the capital gains tax became effective on Jan. 1, 1979, 132,000 new investors entered the stock market in an average month compared to the previous average month figure of 87,000. New capital raised through initial public stock offerings was $2.5 billion more for 1978-1979 than for 1976-1977. This amount of money has the potential to create 160,000 new jobs. Treasury revenue from capital gains increased by $1.8 billion for 1979. In the survey just released for the 12-month period June 1980 to June 1981 - which brought in an additional 2 million new stockholders - capital raised through initial public stock offerings was $4.3 billion more in 1981 than

IN 1980. THIS AMOUNT OF MONEY HAS THE POTENTIAL TO CREATE MORE THAN 250,000 NEW JOBS. TREASURY REVENUE FROM CAPITAL GAINS INCREASED AN ESTIMATED $2 BILLION FOR 1981.

IN OTHER WORDS, WHEN CAPITAL IS LEFT TO WORK IN THE MARKET IT GENERATES APPROXIMATELY 50% OF ITS DOLLAR VALUE IN INCREASED REVENUE TO THE TREASURY. TAKEN OUT OF CIRCULATION BY WITHOLDING BY THE GOVERNMENT, IT GENERATES ZERO INCREASE IN THE REVENUE BASE.

IT MUST NOT BE OVERLOOKED THAT THE FURTHER REDUCTION TO 20% ON TRANSACTIONS AFTER JUNE 9, 1981, AS COVERED IN THE '81 ECONOMIC RECOVERY ACT WHICH THIS COMMITTEE PASSED, WAS NOT INCLUDED IN THE SURVEY. CERTAINLY THEN THIS FURTHER LOWERING OF THE TAX ON CAPITAL GAINS WILL PROVE TO BE AN EVEN GREATER INCENTIVE FOR STOCK INVESTMENT - GIVEN A CHANCE.

IT IS A CLEAR ILLUSTRATION - AS WE AT STOCKHOLDERS OF AMERICA HAVE VEHEMENTLY CONTENDED - THAT GIVEN EQUITABLE AND FAIR TAX INCENTIVES - AND NOT PENALTIES - THE AMERICAN PEOPLE WILL PROVIDE THE PRODUCTIVE CAPITAL TO GET OUR ONCE GREAT AMERICAN BUSINESS MACHINE GOING FULL-SPEED AGAIN.

THIS TREND MUST BE NURTURED. OUR CAPITALISTIC SYSTEM PLAYS A BASIC ROLE IN OUR NATIONAL WELL-BEING AND OUR NATIONAL ECONOMY. IT IS UNIQUE IN THAT. BUT IT WON'T WORK WITHOUT CAPITAL. OUR SYSTEM DEPENDS ON A CONTINUOUS SUPPLY OF NEW PRIVATE CAPITAL AND TO WITHOLD TAXES ON DIVIDENDS IS TO WITHOLD CAPITAL WHICH SHOULD REMAIN PRODUCTIVE. AND HISTORICALLY, THIS WORKING CAPITAL COMES FROM

MILLIONS OF INDIVIDUAL INVESTORS CALLED "THE LITTLE GUYS" WHOSE AVERAGE PORTFOLIO - ACCORDING TO THIS SURVEY - IS $5,450.

FOR A COUNTRY WHICH DEPENDS ON THE CAPITALISTIC SYSTEM IT IS AN ENIGMA WHY WE CONTINUE TO PERSIST IN MISTREATING CAPITAL. WE STILL HAVE A HEAVY TAX ON CAPITAL GAINS, WE HAVE DOUBLE TAXATION ON DIVIDENDS AND NOW THIS PROPOSAL TO WITHOLD 5% ON DIVIDENDS FOR THE INTERNAL REVENUE SERVICE. THIS IS INDICATIVE OF A MISCONCEPTION OF THE VITAL FUNCTION OF CAPITAL IN A FREE-ENTERPRISE SYSTEM AND DIMINISHES OUR NATIONAL PRODUCTIVITY BASE. NO WONDER WE HAVE SUCH A LOW RATE OF INVESTMENT AS COMPARED TO OTHER INDUSTRIAL COUNTRIES.

WE ARE ALL AWARE THAT THE MAIN REASON FOR THIS PROPOSAL TO WITHOLD 5% ON DIVIDENDS IS BASED ON THE BELIEF THAT A PERCENTAGE - A SMALL PERCENTAGE - OF INCOME RECEIVED FROM DIVIDENDS GOES UNREPORTED AND UNTAXED. I DON'T KNOW HOW WE'RE GOING TO LEGISLATE HONESTY. THERE PROBABLY WILL ALWAYS BE SOME CHEATERS AND WE'RE NOT HERE TO DEFEND THEM. THE LAW IS ALREADY IN PLACE TO PROSECUTE THESE OFFENDERS BY FINE OR A JAIL SENTENCE OR BOTH.

BUT THE VAST MAJORITY OF AMERICA'S 32.6 MILLION STOCKHOLDERS ARE HONEST TAXPAYERS AND SHOULD NOT BE KEPT FROM THE FULL USE OF THEIR CAPITAL TO CATCH THE SMALL MINORITY WHO ARE TRYING TO AVOID THEIR RESPONSIBILITY.

ALL CORPORATIONS THAT PAY DIVIDENDS ARE NOW REQUIRED BY LAW TO REPORT ANNUALLY TO THE IRS THE AMOUNT OF DIVIDENDS PAID, THE NAME, ADDRESS - AND MOST IMPORTANTLY - THE SOCIAL SECURITY NUMBERS

OF EVERYONE WHO RECEIVES THEM (INTERNAL REVENUE CODE - SEC. 6109). IN THE CASE OF STOCK HELD IN STREET NAME, THE BROKERAGE FIRM MUST REPORT; IN CASE THE STOCK IS IN TRUST, THE BANK REPORTS.

THEREFORE, THE IRS NOW HAS THE INFORMATION TO MATCH BY COMPUTER THE AMOUNTS OF DIVIDENDS REPORTED BY PAYING AGENTS AGAINST TAX RETURNS FILED. THE ANSWER TO THE PROBLEM THEN, IS ALREADY BUILT INTO THE SYSTEM, WHAT IT LACKS IS ENFORCEMENT. IT IS OUR UNDERSTANDING THAT THE IRS IS UNDERSTAFFED TO DO THE JOB PROPERLY. WE FEEL THAT THE SOLUTION LIES IN INCREASING THE ENFORCEMENT CAPACITY OF THE IRS NOT IN PUNISHING ALL DIVIDEND RECEIVING STOCKHOLDERS TO CATCH THE FEW.

SO ACTUALLY THE 5% WITHELD, IS AN INTEREST-FREE LOAN FROM THE STOCKHOLDERS TO THE TREASURY AND GIVES THE GOVERNMENT THE RIGHT TO LEGALLY TIE-UP AN INDIVIDUAL'S CAPITAL, INTEREST-FREE, AND DEPRIVE THE INDIVIDUAL FROM BEING ABLE TO INVEST OR REINVEST THAT CAPITAL.

FURTHER, THE TREASURY ESTIMATES THAT THREE-FOURTHS OF ALL TAX RETURNS FILED, REPORTED OVERPAYMENT OF TAXES. OVERPAYMENTS ARE EXPECTED TO SOAR THIS YEAR AS A RESULT OF SCHEDULED TAX CUTS AND INDEED THE TREASURY HAS EXPRESSED CONCERN AND THIS PROPOSAL WOULD AGGRAVATE THE PROBLEM.

CAPITAL MUST BE KEPT MOBILE IF IT IS GOING TO GENERATE REVENUE. IT IS AN ACCEPTED FACT THAT ANYTHING THAT HELPS OR HINDERS THE MOBILITY OF CAPITAL, HELPS OR HINDERS ECONOMIC GROWTH.

CERTAINLY, TO TIE-UP CAPITAL UNDER THIS PROPOSAL WOULD DO EXACTLY THAT - HINDER ECONOMIC GROWTH - AND THAT'S NOT IN THE BEST INTEREST OF OUR ECONOMIC RECOVERY. AND ECONOMIC RECOVERY IS WHAT WE ALL WANT, ISN'T IT?

AGAIN, THANK YOU.

STATEMENT OF CHARLES A. BRUNING ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

I am Charles A. Bruning, President of the Edgewood Bank in Countryside, Illinois. I am also the Chairman of the Community Banking Leadership Council of the American Bankers Association. Accompanying me is Paul R. Claytor, a member of the Taxation Committee of the American Bankers Association, who is the Vice President and Director of Taxes for the American Fletcher National Bank in Indianapolis, Indiana. I would like to thank the Committee for this opportunity to testify on behalf of the American Bankers Association on the tax proposals contained in President Reagan's budget message. The American Bankers Association is the national trade organization for more than 90 percent of the nation's 14,500 commercial banks, including more small banks than any other financial trade association.

Before commenting specifically on President Reagan's recent tax proposals, I believe it would be appropriate to comment on the circumstances under which these proposals have been made.

There were four basic objectives set forth in President Reagan's economic program:

(1) The reduction of individual and business taxes to stimulate saving, investment, work effort, and productivity.

(2) The reduction of the growth of Federal spending.

(3) The reduction of the burden of excessive Federal regulation of personal and business decisions.

(4) The reduction and control of inflation through monetary policy.

We supported that program when it was proposed and we support it now. In order for the program to be successful, however, it is important that reductions in taxes be matched by reductions in Federal spending. Although great progress was made toward the goal of reducing spending in the first session of this Congress, somewhat greater progress was made toward reducing Federal taxation with the result that the deficit projected for fiscal year 1983 is, at least, on the order of $100 billion. The recession makes the problem more complicated and its effects more severe as tax receipts are driven down and demands on unemployment assistance and other social support programs are increased.

The need to bring Federal revenues and expenditures closer together is clear. What is not clear is how this may best be done without aggravating the problem. Short term budgetary benefits of tax increases may have significant adverse effects in the long term. Furthermore, as Secretary Regan noted in his testimony before you on February 23, "There are behavior changes and economic repercussions from tax and spending shifts which affect saving, investment, labor supply, income and revenue. Very often, changes which may look good on paper will buy little or no progress toward solving a budget problem, especially compared to the economic cost to the whole nation of the policy shift."

As citizens and taxpayers, we share your concern and the President's concern over the projected increase in the Federal deficit. Of equal importance, however, is that the impact of certain aspects of the President's tax proposals on individual and business investment decisions and on the financing needs of state and local governments be clearly understood.

Before addressing details of the proposals which we find troubling, let me discuss briefly with you two matters which should be placed on the table at the outset of our discussion: First, the effective rate of Federal income tax experienced by banking generally. Second, the relationship between high interest rates and bank earnings.

EFFECTIVE RATE OF FEDERAL CORPORATE INCOME TAX

In its General Explanation of the President's tax proposal, the Treasury Department states that "The proposed corporate minimum tax would tax 'corporate profits' as measured by regular taxable income plus certain special deductions, and would apply only to those corporations that pay very low regular rates of tax". The Technical Explanation then goes on to say the "industries that will increase their share of corporate tax liability, on the basis of their current use of tax preferences, are petroleum, banking, and utilities". The effective rate of Federal income taxes paid by banks is probably lower than the effective rate for some other industries. It would be incorrect and unfortunate for the Committee to infer from these statements that banks pay "little or no Federal corporation income tax, despite reporting large profits to their shareholders", as it is put in the General Explanation.

All such comparisons by industry of effective tax rate should be re-examined in the light of the Economic Recovery Tax Act of 1981. No one knows what the effective rate of tax on any industry will be for 1981 because the returns are not in. What is known is that the combination of the accelerated capital recovery system and safe harbor leasing (not commercial leasing) heavily favor capital intensive--as opposed to service--industries.

The Administration's tax proposals, according to the technical explanation, would increase banking's share of the corporate income tax burden from 1.9 percent to 2.9 percent, the largest percentage increase for any industry. According to the Treasury Department's Statistics of Income for 1977, the most recently published statistics available, banking's share of corporate net income was 2.2 percent and its share of the corporate tax burden was 2.2 percent, or $1,265,984,000.

According to the 1980 Annual Report of the Federal Deposit Insurance Corporation, the Federal income tax provision for all insured banks for 1980 was $2,466,000,000. The amount actually paid in 1980 was somewhat lower because the annual tax provision includes that portion of deferred tax liabilities allocable to the current year which are payable in future years.

To be fair about such industry-by-industry comparisions, one must increase the nominal effective rate for banking, or lower it for other industries, by a factor that reflects accurately the impact of reserve requirements placed on banks under the Federal Reserve System. Under the Monetary Control Act, financial institutions must post reserves with the Federal Reserve System on an interest free basis in direct ratio to their transaction accounts and nonpersonal time deposits. The reserves held by the Federal Reserve System are then invested primarily in government securities. Out of the $11.7 billion paid into the Treasury by the Federal Reserve system for fiscal year 1980 as receipts in excess of its operating costs, over 20 percent, approximately $2.4 billion, was generated by the investment of reserves. No other industry is subject to reserve requirements or is responsible for such Treasury receipts. This is often overlooked when discussing effective income tax rates, yet th[illegible] effect is the same as if a tax had been imposed directly [illegible] the banking industry as a whole. Revenue contributed by financial institutions indirectly through the Federal Reserve's earnings on reserves for 1980 more than doubled the amount commercial banks contributed to the Federal Treasury directly through Federal income taxes.

It would be less than candid for me, however, not to discuss the additional element that for many banks reduces the effective rate of Federal income tax calculated as a percentage of total pre-tax income. I am speaking of income from state and local obligations which, as you know, is not subject to tax under the Internal Revenue Code. Calculated as a percentage of gross income, bank earnings from state and local obligations have been dropping steadily over the past six years, from 7.4 percent in 1975 down to 4.3 percent in 1980. FDIC 1980 Annual Report, Table 115. The trend is actually sharper than it appears, as earnings per $100 of investment in these obligations has increased over the same period from $4.97 per $100 in 1975 to $5.86 per $100 in 1980. Ibid. As a percentage of total assets, state and local obligations amounted only to slightly less than 8 percent in 1980, but the effect these assets had on earnings was disproportionately large due to the high operating expenses incurred by banks during 1980.

In summary, it is clear that commercial banks have borne their fair share of the corporate tax burden based upon corporate taxable income. Commercial banks, in addition, have provided, through the Federal Reserve System, an equal contribution to the Treasury as earnings on reserves invested by the Federal Reserve. It is only when their tax-exempt income is taken into account that their effective rate of Federal income tax--as a percentage of all earnings--is reduced to a level at which the proposed alternative minimum tax begins to bite.

The reduction of banking's effective tax rate is not, therefore, attributable to "the use of special types of financial arrangements or legal devices (which) allow one taxpayer to pay a much lower tax than similar taxpayer engaged in exactly the same activity", as Secretary Regan characterized the "abuses" the tax proposals are designed to eliminate. It is, in large measure, simply the result of commercial banking's traditional function as substantial purchasers of state and local debt at yields below those the governments would have to pay on bonds subject to Federal tax.

RELATIONSHIP BETWEEN INTEREST RATES AND BANK EARNINGS

It goes without saying that we are all concerned about the present rates of interest. What is of great concern to me and to the American Bankers Association, is that there is a public misconception that banks are either responsible for these rates or that banks benefit from them.

Chart 1 compares interest rates and commercial bank profitability over the thirty years from 1950 to 1980. As you can see, net income after tax as a percentage of assets for commercial banks has held relatively steady, while interest rates have moved sharply upward. Table 2, based on Forbes Magazine's annual survey, compares the profitability of banks with the profitability of other industries. Bank profits, as compared with other industries' profits, have steadily declined since 1970. Although there are many factors involved in profitability, including declining deposit base and the expenses of the new technology needed to provide the convenience and security bank customers deserve, the increase in the cost of funds to banks is perhaps the single most important factor in increased costs and lower profitability.

ALTERNATIVE MINIMUM TAX FOR CORPORATIONS

The largest single revenue increase in the Administration's proposal would come from an alternative minimum tax for corporations. The current minimum tax would be repealed and replaced in 1983 with a tax of 15 percent on corporate taxable income, determined without regard to the net operating loss deduction, plus certain tax preference items. Banking is singled out for the largest increase in corporate tax burden (53 percent), followed by the petroleum industry (both refining and extracting) at 27 percent, and the utility industry at 15 percent. The largest share of the increase in banking's income tax burden appears to be attributable to the inclusion in the minimum tax base of a portion of total interest expense attributed to support of tax-exempt investments. Other tax preference items affecting banking more than other industries are:

(1) Loan loss reserves in excess of those determinable under the experience method. This is the same item as in current law but would have greater impact due to the way this tax is

computed.

(2) Lessors' leasing benefits.

(3) Excess interest deductions on original issue discount obligations.

The only credit allowable against the tax would be the foreign tax credit, limited to taxes paid on preference-related foreign source income and creditable only to the extent that the taxes were not imposed at a rate higher than 15 percent. A minimum tax credit - the excess of minimum tax over regular tax - would be carried forward against future regular tax liability.

You will by now have heard from serious and articulate critics of the proposed alternative minimum tax. We, too, would urge you to examine alternatives carefully. Rather than discussing the relative merits of the minimum tax approach, we, believe that it might prove more constructive and more useful to you to point out the effect certain aspects of the minimum tax proposal will have unless the proposal is abandoned or modified substantially.

TAX PREFERENCE ITEMS

Interest On Indebtedness To Carry Tax-Exempt Securities

Among the tax preference items listed in the Administration's minimum tax proposal, this item, described as "deductions for debt to carry tax-exempt securities" is clearly of greatest concern to banks. It is even more important, perhaps, to state and local governments.

Under section 265(2) of the Internal Revenue Code of

1954, a taxpayer may not deduct interest paid on debt incurred to purchase or carry tax-exempt obligations. The Treasury Department's technical explanation states that the normal rule of section 265(2) does not apply to commercial banks, or to other financial institutions having less than 15 percent of their total assets invested in tax-exempt obligations.

This matter has been the subject of a number of controversies between banks and the IRS over the past sixty years. Perhaps the best explanation of why section 265(2) has not been applied to banks' interest expense is IRS's own explanation in Revenue Procedure 70-20, which was issued for the purpose of setting forth guidelines for taxpayers and the IRS for the application of section 265(2) to banks holding state and local obligations: "It is clear from the legislative history . . . that Congress intended to disallow interest under such section only upon a showing of a purpose by the taxpayer to use borrowed funds to purchase or carry tax-exempt securities. It is clear that indebtedness incurred by reason of deposits in a bank is not incurred to purchase or carry tax-exempt securities. The Congress has repeatedly recognized that indebtedness incurred by a bank to its depositories is not to be treated as indebtedness incurred or continued to purchase or carry tax-exempt securities. . . To do so would seriously interfere with the marketing of government securities, which are bought for the most part by banks. . . The primary purpose of a commercial bank is to make available to one segment of society money which is excess to the current needs of other segments of society. Because a large part of its indebtedness is subject to payment on immediate and short-term demand as contrasted to the money it lends, it must have considerable flexibility as to the source of its funds." The Revenue ruling concludes by holding that "section 265(2) should not be deemed applicable to interest paid or accrued by banks on indebtedness which they incur in the ordinary course of their day-to-day business unless there are circumstances demonstrating a direct connection between the borrowing and the tax-exempt investment. . . A direct connection will not be inferred merely because tax-exempt obligations were held by the bank at the time of its incurring indebtedness in the course ot its day-to-day business."

In December, 1980, the IRS issued Revenue Procedure 80-55, which would have denied banks a deduction for interest paid to state and local governments on deposits secured in accordance with state and local law by tax-exempt securities. In March, 1981, the Commissioner of Internal Revenue and the Assistant Secretary of the Treasury for Tax Policy withdrew the revenue procedure and announced that the revenue procedure "failed to give adequate consideration to the basic treatment accorded bank deposits under the longstanding administrative interpretation of section 265(2)".

There is, it may be argued, no exception for banking from this general rule. As with all other taxpayers, section 265(2) denies banks the deduction for interest on debt incurred to purchase or carry tax-exempt obligations. As noted by the Commissioner and the Assistant Secretary in their joint statement, section 265(2) will be applied "to interest paid on deposits which are incurred outside of the ordinary course of the banking business, or in circumstances demonstrating a direct connection between the borrowing and the tax-exempt obligations." This is consistent with case law and IRS rulings spanning the period from 1917 to the present and this interpretation of the statute has been reaffirmed by the Congress on numerous occasions.

The inclusion of this item in the minimum tax base arbitrarily treats a portion of a bank's cost of funds--its chief cost of doing business--as incurred to purchase or carry all tax-exempt securities held by it, and applies the minimum tax rate to some portion of the bank's interest deduction. This goes far beyond the rule of section 265(2) by establishing, in effect, an irrebutable presumption that a bank incurs a portion of its current interest expense for the purpose of carrying tax-exempt securities regardless of yield or date of purchase. Furthermore, the Technical Explanation gives no guidance as to how this allocation of interest expense is to be made.

Banks purchase tax-exempt securities for a number of reasons. Commercial banks have traditionally provided 40 to in effect, eliminating at least 40 percent of the market for these bonds at their lower-than-taxable yields. Preliminary estimates of the impact this would have on the tax-exempt bond market suggest that it would result in an increase in borrowing costs to state and local governments of as much as 220 basis points (2.2 percent) in yield. This increase in financing costs for state and local governments would come at a particularly tough time, as those levels of government are being asked to shoulder more of the burden of programs which have been carried out by the Federal government. In addition to creating increased state and local taxes to support the more expensive issues, this action could increase the financing costs for large municipal projects to unacceptable levels, resulting in additional unemployment, with its consequent costs to Federal, state, and local governments.

Finally, it should be pointed out that this is one of only a few items in the Administration's minimum tax preference item list which is not a timing difference. With, for example, the excess original issue discount item, one can view the minimum tax as the cost to the taxpayer of taking a deduction earlier than it would otherwise be allowed. This item is completely different. It not only represents a substantive change in a long standing United States tax policy, it has serious consequences for persons other than the taxpayer directly affected. The ABA believes it is bad policy and goes beyond a termination of the rule applied to commercial banks under section 265(2) for over half a century, a rule reaffirmed by the Congress on numerous occasions.

Reserves For Losses On Bad Debts Of Financial Institutions

The inclusion of the amount by which a bank's deduction for additions to its loan loss reserve under the percentage method exceeds the amount deductible under the experience method as a tax preference item is consistent with its treatment under the current minimum tax. Due to the way in which the alternative minimum tax would be computed under the Administration proposal, however, the impact would be greater than under the current minimum tax. Ironically, this will take effect just as the percentage provided for additions to the loan loss reserve will drop from 1.0 percent, as provided by the Economic Recovery Tax Act of 1981, to .6 percent, and at a point in the current business cycle at which loan losses are increasing to levels in excess of the expiring percentage method amount for many banks.

The ABA believes that the present percentage level for loan loss reserve additions should be preserved and, in fact, should be increased. While the level of losses for the banking industry as a whole amounted to approximately one-half of the maximum rate of allowable reserve additions provided by section 585 for 1981, many banks experienced losses equal to or greater than the 1.2 percent level in limitations otherwise applicable. Further, if the item relating to tax-exempt bonds held by commercial banks is included in the minimum tax base, it would be impossible for a bank to avoid the minimum tax without selling its tax-exempt portfolio and any such sale would be at loss levels likely to produce a net operating losses which would have to be carried over to other taxable years. Since the minimum tax would disregard the net operating loss deduction, the bank would be trapped either way and probably exposed to minimum tax for years in which it otherwise would not be affected by the minimum tax. This feature truly unnecessarily multi-year calculations arising out of net operating loss carrybacks.

WITHHOLDING AT SOURCE ON DIVIDENDS AND INTEREST INCOME

The ABA is opposed to the Administration's proposal to institute a system of withholding at source on dividends and interest income. This proposal, if adopted, would require banks and other financial intermediaries to withhold 5% of the income earned on all types of financial instruments, to remit these monies to the Treasury, and to document such transactions with information returns supplied to the Internal Revenue Service and to the customer. These requirements, though superficially facile, are complex, costly, and time consuming to both the bank and the customer. These requirements would deter savings, impose substantial cost burdens on the public and would not apply fairly to all taxpayers. In addition, the proposal is contrary to the Reagan Administration's program to reduce federal paperwork requirements.

Mr. Chairman, the ABA strongly supports the efforts of the President and the Congress to promote economic development and balance the budget through fiscal restraint. If inflation is to be cured it is essential that the federal budget be brought into balance and savings and investment be increased to enhance productivity. Bankers are committed to the achievement of this goal and we will do all in our power on its behalf.

The ABA also strongly agrees with the Treasury that increased incentives must be developed to encourage further taxpayer compliance with the tax laws and reduce the magnitude of the underground economy. The ABA vigorously supports efforts to develop incentives to encourage taxpayers to voluntarily and fully report their income. The Association and its members have worked diligently over the years to improve the current information reporting system, both the bank operations and the internal IRS procedures.

The increasing disrespect for the voluntary nature of our tax system is undermining its very feasibility. However, imposing universal withholding will only further reduce "voluntary" to a hollow, meaningless word, a mere facade for what is really a compulsory system. Other more palatable mechanisms must be developed. The ABA stands ready to assist the Treasury and the Congress to explore the possibilities.

many banks are presently (or are considering) not taking small accounts, charging monthly or quarterly service fees for small accounts, or not paying interest on such accounts. With the additional costs of withholding, maintenance of exemption certificates, and increased information reporting, an even greater number of financial institutions are likely to discontinue the acceptance of small accounts or to raise the minimum balance requirements or charges. In many banks, withholding would drive these small accounts out of existence. In addition, efforts to provide returns on previously non-interest bearing deposits (transaction accounts such as NOW accounts, share drafts and automatic fund transfers) would be thwarted by higher transaction charges or minimum balances in order to cover the costs of withholding.

Unlike wage withholding, which applies evenly to all employers, the burden of withholding on dividends and interest will be concentrated on financial institutions, particularly full service banks. This is because of the wide range of depository, fiduciary, and financial agency services which commercial banks offer to their customers.

A typical bank may offer the following interest bearing accounts or instruments:

1. Regular passbook account
2. Christmas Club account
3. Time deposit, 30 month
4. Time deposit, 4 years

5. Time deposit, 6 years
6. Money Market certificates
7. Negotiable certificates of deposit
8. Bankers acceptances
9. Repurchase agreements
10. NOW accounts

The typical bank also may collect or redeem the following in an agency capacity, normally as an accommodation for customers at cost:

1. Corporate bond coupons
2. Series E and EE bonds
3. Government and government backed securities, (T-bills, GNMAs, etc.)
4. Commercial paper

The typical bank with a trust department may offer these personal and corporate trust and financial services:

1. Paying agent for dividends
2. Paying agent for registered bonds
3. Paying agent for bearer bonds
4. Personal trusts
5. Investment Management accounts
6. Custodial accounts
7. Dividend reinvestment agent

The list in each area could be expanded because each bank offers a range of services tailored to meet their individual customer needs.

This wide variety of savings instruments offered, as misinformed as to his current balance of funds available for withdrawal, and the institution might be subject to liability. Also without deductions and notice of withheld taxes, it is likely that many persons with NOW accounts, share drafts, and ATS arrangements might write checks or share drafts that would be dishonored because of this minimum balance requirement.

The tax code allows a holder of Series E bonds to report interest annually and pay the tax liability. Under the proposal 5% of total interest is to be withheld when the bond is redeemed. Thus, this could result in a withholding for tax already paid. Many types of interest-bearing deposit accounts provide penalties for early withdrawal. Withholding presumably would have been applied to the higher rate. If a person withdraws and the penalty is applied the amount already withheld may well exceed the tax owed.

Effect on Savings

All of these monetary burdens, inequities and inconveniences are bound to slow our current savings rate even more.

There is a theory expressed by some that except for the lost interest on interest and the amounts which non-taxpayers fail to recover through refunds, the remainder of the amount withheld will find its way back into savings and investment if the taxpayer would have otherwise left them in savings and investment. This theory ignores human nature and the current savings environment. Many savers set aside so much each pay period and budget themselves to live on the remainder of their wages, including payment of their income taxes. Sometimes it is difficult, but they are reluctant to invade their savings including earned interest. On the other hand, if 5% is withheld and subsequently refunded in whole or in part it is easier to consume. Likewise, current earnings that might otherwise have been used to pay tax liability arising from savings will be consumed.

Supporting the human nature response to the theory is the fact that the withholding may have come from interest on a two and one half year time deposit or other type deposit requiring minimum size and the refund would not be large enough to deposit at the higher rate. Thus the incentive to save would be diminished.

The same result occurs but with more certainty in the case of dividend reinvestment plans. Under such a plan the investor makes a decision to save by reinvesting automatically his or her dividends in more company stock. The saver is encouraged to do this by lower or no brokerage costs, and possibly a discount price from the market price. If 5% of the dividend is withheld there will be a 5% smaller investment and unless the plan has a provision for participants to invest additional funds the saver is forever foreclosed as to the 5% withholding of enjoying the plans' investment incentive.

Clearly, this will have an adverse impact on our

It would be relatively mechanically easy to secure the execution of an exemption certificate when accounts are opened or shares are acquired, but this is normally done during taxpaying years. It is the elderly, who already have their accounts, and who rely most heavily on interest income for support, who would need to file the certificates. Processing certificates for existing accounts would be very costly and require substantial lead time to implement. In addition, who is going to inform our senior citizens that they are going to lose 5% of their income unless they file an appropriate number of exemption certificates or file a refund claim? Who is going to explain the law and see they are protected?

Again, it is important to recognize that withholding would apply to a variety of depository accounts such as regular savings accounts, club accounts, certificates of deposit, time-open accounts and special notice savings accounts, all of which pay interest on a periodic basis. Depositories also issue and redeem short-term certificates such as money market CDs, which pay interest only at maturity. While some banks' recordkeeping systems may allow the use of a single exemption certificate for depositors with more than one account, it is probable that in most cases separate certificates may be required for each account. Similar problems may arise in the case of certificates of deposit which are renewed or rolled over at maturity. Certain types of interest payments, such as corporation bearer bonds with coupons and short-term money market discount obligations, may require certificates for each transaction unless there is a continuing relationship with the same institution.

Depository records, such as ledger cards or program codes, would have to be periodically updated to reflect a change in status. It is also unclear whether withholding would have to be adjusted to reflect change in status. Further cost would be incurred in providing copies of the certificates to the IRS and for storage and retrieval of copies in response to examination of the taxpayer or the paying institution.

It is important to recognize that many interest payments by depositories, other than those covered by exemption certificates, will not be subject to withholding, such as payments to corporations, tax-exempt organizations and non-taxable accounts (such as deposits of non-resident aliens and foreign residents and IRA and Keogh accounts). Therefore, depositories would be required to review all existing accounts to determine if withholding will apply to the payee.

As referenced before, withholding on deposit accounts is only one of the numerous ways in which withholding-at-source would affect commercial banks. Banks would be required to withhold on dividends paid to their own stockholders as well as interest paid on their capital notes and debentures. Banks would also have to withhold with

U.S. Savings Bond Redemptions

Presently, many financial depositories act as paying redemption agents for U.S. Treasury savings bonds, with banks alone accounting for 92% of bonds paid. In calendar year 1979, over 170 million bonds were redeemed; for the first quarter of 1980, there were 68 million redemptions. In effect, withholding or an exemption certificate would be required as to each bondholder, and, additional information reports would be required for these payments. This would require the establishment of an account for each person who redeems a bond. This increase in costs to the bank for redeeming savings bonds would have to be passed on to the Bureau of the Public Debt or many institutions would cease handling redemptions.

Treasury and Money Market Bearer Obligations

Another class of withholdable payments to which information reporting does not currently apply is marketable U.S. Treasury debt. While a substantial portion of the estimated 34 billion dollars held by individuals is in registered form or held in book entry accounts at the Treasury, approximately half of such volume is held in book-entry accounts at banks and securities dealers or is in bearer form. A rough estimate of individual holders is 8 million. Banks will also be required to withhold and report for an undetermined number of individuals holding commercial paper, for which banks act as issuing or paying agent; U.S. agency and Farm Credit system bearer or book-entry obligations; and banker acceptances. While individuals hold a small percentage of the dollar volume of these obligations, they represent as much as 30% of transactions. Again, each transaction requires withholding or an exemption certificate and the establishment of an account for reporting to the government and the customer.

Implementation Time

Should the congress adopt the withholding proposal it will take many banks many months to implement the program even if they gave it the highest priority, setting aside their efforts in other areas. It would be impossible to be ready by January 1, 1983. The task is just too big.

Increased revenues to the Treasury

The Administration estimates that the proposal will result in increased revenue of 500 million in fiscal year 1983, $1.1 billion for fiscal year 1984, $1.2 billion for fiscal year 1985, $1.4 billion for fiscal year 1986, and $1.5 billion for fiscal year 1987. When the Arthur Young Company studied the revenue estimates given for the Carter withholding proposal, they questioned the reliability of the estimates and suggested the actual revenue gains would be substantially less. The figures given for the Reagan withholding proposal are presumably no more reliable than those given two years ago. It should be noted that withholding may not provide any significant collection of tax revenue from the willful non-filer. Through such devices as misuse of exemption certificates, shifts to nonwithholding investments, the willful noncomplier will withheld.

Withholding at source will ensure collection of 5% as to all taxable payments of interest and dividends, but it will not alleviate or relieve the need for a full matching program for information reports and a collection effort as to unreported or unpaid amounts. In fact, with the expansion in the number of payments subject to information reporting and withholding, the number of information returns requiring processing will be substantially increased. The introduction of the exemption certificate program provides an opportunity for abuse. Therefore, the IRS would be required to match all information statements that do not report any tax withheld with taxpayer returns or attempt to verify whether the taxpayer was a legitimate nonfiler in cases where no return was filed. Matching would also be required to determine if tax liability was fully paid in cases of taxpayers with effective tax rates higher than 5%. Obviously, the same problems as to securing responses to IRS inquiries and to collect amounts when deficiencies are determined will still prevail. In discussing the efficiency of withholding over information reporting there is a failure to address the lack of economy where billions of dollars are overwithheld and must be refunded, and millions of taxpayers suffer a loss of earnings through the acceleration of their tax payments and such overwithholding. Third, the letter cites that failure of payors to fully comply with information reporting requirements limits the use of information statements. The same problem will still exist unless the additional burden of withholding would make payors more meticulous. With withholding mistakes the taxpayer would more often be the one prejudiced. Finally, the letter notes that extensive pursuit of taxpayers does not achieve full collection where taxpayers cannot be traced or where it is uneconomic to collect taxes even if they have been assessed. Admittedly 5% tax is better than nothing, but we repeat compliance efforts would still have to be maintained to collect any additional amounts due above 5% or all the tax due from taxpayers wrongfully filing exemption certificates or using other withholding evading practices.

Tax Equity

The Treasury states that interest and dividend income is essentially the same as income from wages, and the recipients thereof should pay their taxes with no less certainty and just as promptly. The application of withholding at source to wage payments, adopted in 1962, represented a drastic departure from our system of self-assessment. It was generally accepted by the public because wage payments usually involve a single employee in direct relationship with his employer. Wage withholding provides a mechanism for claiming all deductions, exclusions, exemptions and credits against such income. In contrast, withholding of interest and dividends involves a more remote relationship with potentially large numbers of payors of interest and dividends. Moreover, there is no

Table 1

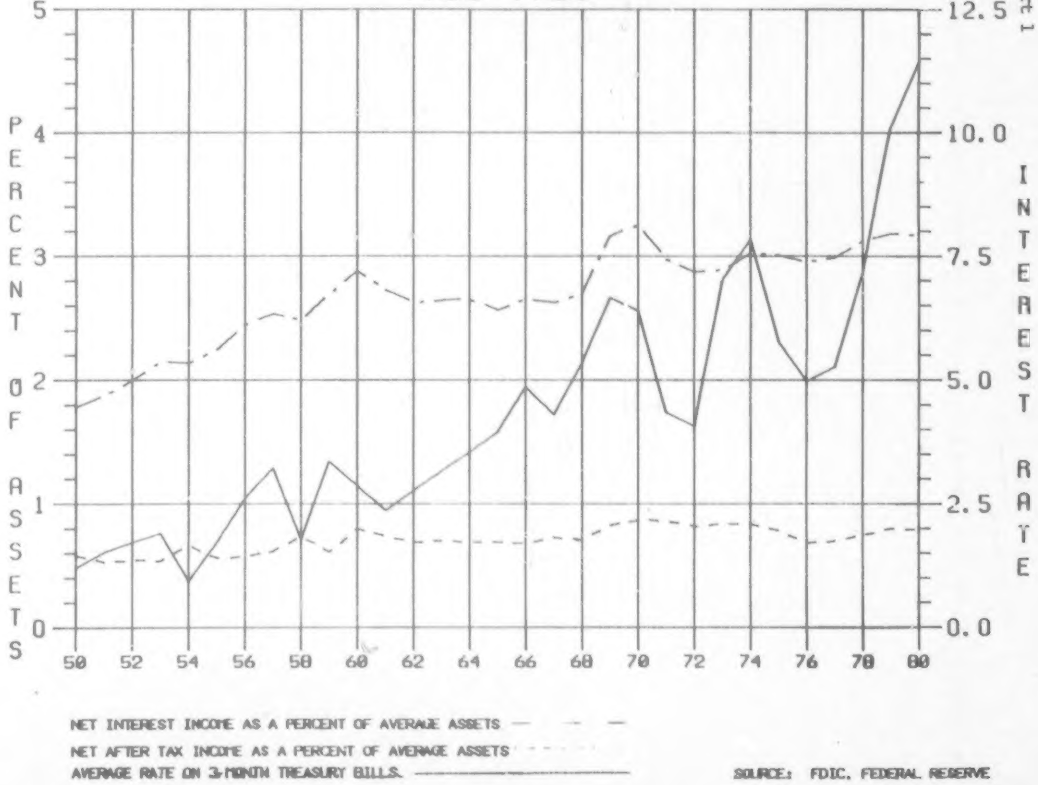
1977 Statistics Of Income
Corporation Income Tax Returns
(000 omited)

	All Industries[1]	Banking[2]
Net income (less deficit)	219,243,043	4,919,457
Net income	245,274,490	5,590,306
Income subject to tax	212,501,782	4,828,737
Income tax, total	96,340,453	2,153,992
Additional tax for tax preferences	263,316	8,452
Foreign tax credit	(26,006,028)	(586,838)
U.S. Possessions tax credit	(837,687)	-----
Investment credit	(11,038,404)	(259,820)
Work incentive credit	(19,327)	(179)
New Job Credit	(1,703,838)	(49,623)
Income tax plus preference tax less credits	56,998,485	1,265,984

1 Source: IRS publication 16(12-81) p. 27
2 Source: IRS publication 16(12-81) p. 33

Chart 1

INTEREST RATES AND COMMERCIAL BANK PROFITABILITY 1950-1980



SOURCE: FDIC, FEDERAL RESERVE

Table 2

--Net Income as a Percent of Average Assets--
Rank of Bank Profitability Compared to 30 Other Industries 1/

Year	Rank
1969	21
1970	23
1971	17
1972	8
1973	8
1974	9
1975	9
1976	17
1977	23
1978	23
1979	23
1980 2/	40

1/ From Survey of Industry conducted yearly by Forbes magazine.

2/ 49 industries surveyed.

The **Chairman**. Senator Byrd.

Senator **Byrd**. Mr. Bruning, yesterday witnesses representing city and county government testified that including interest on their bonds as a preference item, subject to a 15-percent minimum tax, would make banks reluctant to purchase the bonds and would raise the interest rates on the bonds.

I gather from your testimony that that is your view. Is it?

Mr. **Bruning**. Yes; it is.

Senator **Byrd**. And how much would interest rates on the bonds rise, in your judgment?

Mr. **Bruning**. Well, they could rise substantially, from nontaxable levels to taxable levels, 200 to 300 basis points in the market.

Senator **Byrd**. Do you mean just by making it a 15-percent preference item?

Mr. **Bruning**. Just by making it a 15-percent preference item. Yes, Senator. In fact, this preference item which has been called "an alternative minimum tax" I think is really a maximum tax.

Let's take an example of a community bank that may be having earnings problems because of a high amount of real estate mortgages similar to the thrift industry; it is not generating a lot of net income. Including the interest expense as a preference item for carrying those municipal securities could or would create a minimum tax in an institution that isn't paying any income taxes or little income taxes because of economic conditions. In that instance, municipal securities have little value for that financial institution. In order to be encouraged or induced to purchase additional securities their rates would have to be substantially higher.

Senator **Byrd**. On an average, what tax do banks pay now? To just take a figure, suppose net income prior to Federal income taxes would be $500,000. What percentage of that would be paid in Federal income taxes? Is there an average?

Mr. **Bruning**. Well, the statistics for 1980 put out by BAI show that the median effective tax rate was 21.42 percent. And the FDIC 1980 annual report also reflects that the overall tax rate, effective rate, for banks under $500 million was 17.99 percent. Now, it will vary across the board, of course, between large banks and small banks.

Senator **Byrd**. Sure. But that's not really a high rate, is it?

Mr. **Bruning**. Well, I think it's a very high rate in terms of effective rates being paid. With the full taxable rate at 46 percent, we are approximately almost 50 percent there. And when you include that $2.4 billion of interest income to the Treasury which we are not receiving as interest income, that is in the form of a tax, also, because it is being generated to the Treasury in the form of investment earnings on our reserves. So our tax rate, effectively, could be as high as 40 percent.

Senator **Byrd**. Thank you.

The **Chairman**. Senator Boren?

Senator **Boren**. I am going to ask you to repeat the answer you gave to Senator Byrd. How much do you think the municipal bond costs would go up?

Mr. **Bruning**. The municipal bond financing costs could go up about 200 possibly 300 basis points from current levels.

Senator **Boren**. Right.

Ms. Sullivan, I wanted to ask you—I was interested in this model you gave in terms of the idea of the capital being in circulation and generating additional economic growth—have you narrowed this down enough to determine the amount of economic growth that would be lost if that capital were withheld and taken out of circulation in a year's time?

Ms. SULLIVAN. No; but we could do it for you.

Senator BOREN. I would be very interested in seeing that.

Ms. SULLIVAN. All right.

Senator BOREN. Because I think certainly you made a very good point about that, and I think that's something that adequate consideration has not been given to.

Ms. SULLIVAN. Thank you. I am glad you thought so, too, because this is one of our main points.

Senator BOREN. Well, I think it is a very important one, and I think it would be helpful if we could draw the model on out further and try to make a calculation of just how much would be lost in terms of economic growth and, in return, eventual tax collections back to the Government as well, by taking that capital out of circulation—withholding it at an earlier period.

Ms. SULLIVAN. We will develop that information for you.

Senator BOREN. I would appreciate it. And if you do, we will put it into the record later on.

Ms. SULLIVAN. Thank you.

[The information follows:]

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OFFICE OF
THE PRESIDENT

April 1, 1982

Senate Committee on Finance
Room 2227
Dirksen Senate Office Bldg.
Washington, D.C. 20510

At Senator Boren's request to determine the amount of economic growth that would be lost if the capital witheld by a 5% witholding on dividends was taken out of circulation in a year's time, we have further developed the facts and figures pertaining to the potential negative effect it might have on the economy.

We will use figures we obtained from IRS for 1981 and relate them to the figures we presented in our testimony on the increase in capital investment for 1981. According to the IRS, American companies paid approximately $79 billion in dividends in 1981. This of course is a tentative figure, according to IRS, and will probably be revised upward when all the data for 1981 is collected.

Using the $79 billion as our base figure, if 5% had been witheld from dividends in 1981, the potential amount of capital kept out of circulation in the market would have been approximately $3.95 billion. This amount of capital invested has the potential to generate 230,000 new jobs and bring in an additional $1.65 billion in new revenue to the Treasury.

Relating the hypothetical 5% witholding on dividends for 1981 ($3.95 billion) to the increase in capital investment for 1981 ($4.3 billion) which brought an additional $2 billion in new revenue to the Treasury and had the potential of creating 260,000 new jobs - the witholding would in effect have wiped out the gains made through incentives which brought new investment capital into the market.

Further, IRS estimates the lost revenue in tax on dividends through undereporting was $3.4 billion in 1981. We believe that enforcement is still the best solution to the problem. i.e. Had the IRS had proper enforcement and no witholding of 5% on dividends in 1981, not only would they have recovered the $3.4 billion in tax revenue lost to undereporting, but added a potential $1.64 billion in new revenue generated from the capital that had been left to work in the market, for a net gain in tax revenue of $5 billion.

We appreciate your including these facts in the record of our testimony.

Sincerely,

Margaret Cox Sullivan

Margaret Cox Sullivan

MCS:pb

The **Chairman.** I appreciate very much your testimony. I think we were faced with a problem. Wage earners, for example, as Mr. Cohen and you all know, pay 99 percent of their taxes, and we are trying to figure out a way for other people to pay taxes who don't report their income. There are a lot of people who have interest and dividend income but who don't report it.

But I don't want to suggest that just because somebody says withholding causes more paperwork we ought to throw it out the window, because the estimates we have are that between 13 and 19 percent of the income is not reported. Forty-six percent, I think, of capital gains is not reported. That is over $5 billion in taxes we are losing every year.

Now, it's one thing to say it's inconvenient, but we are losing that much revenue. There is a GAO study out just yesterday. We have got an obligation in this committee to make certain that some people pay some taxes before we go back and ask others to pay more taxes. That would help on the minimum tax, if the banks would come in and say, "Well, we don't see any problem with paperwork on withholding of interest and dividend income; but we would rather do that than have the minimum tax." So maybe that is something you might want to consider.

Mr. **Cohen.** Mr. Chairman, we considered that and dealt with it in our written statement. I was going to comment on it, but I didn't want to take up the time of the committee in the light of your comments.

But we agree entirely with this. On the other hand, we think that the method that is contained in your bill is better directed to do this, if I may say so. For example, the Treasury proposal is essentially the same as the one proposed in 1980, except they have reduced the rate of withholding to 5 percent.

The **Chairman.** And they have an exemption there for the elderly who owe tax of not more than $500—$1,000 if a joint return is filed.

Mr. **Cohen.** Well, we estimate that about 40 percent of the 18 million shareholder accounts in mutual funds would be entitled to file those exemption certificates, all of which have to be processed. And we estimate the cost.

On the other hand, your proposal, according to our records, would affect less than 4 percent of the shareholders, would produce three times as much in withholding tax at a 15-percent rate, and we think it would be much more effective.

The **Chairman.** Right.

I remember what Secretary Regan said in a Press Club speech. He was asked a question about this proposal, and he indicated the President was only lukewarm. So if he is only lukewarm, there is nobody going to catch fire up here on it. [Laughter.]

So I don't really believe it is going to happen.

But we do have a problem. The IRS statistics show that about 15 percent of all form 1099 information reports do not have the correct social security number.

Mr. **Cohen.** In the mutual fund industry we think it's less than 4 percent.

The **Chairman**. The absence of a social security number means that the report is virtually useless. So we are going to have to figure out some way to make it useful.

Mr. **Cohen**. Yes.

The **Chairman**. I'm certain you all agree that there is no problem with that.

Mr. **Cohen**. We think the system that you have put into that bill is far better suited to this than the across-the-board withholding that has been suggested in the past.

The **Chairman**. Again, I don't want to shoot down any administration proposal prematurely, but I would guess if we can work out something on the other side, a little more information, better reporting, we'll see how it works. If it doesn't work, then you go back to something else.

We are told, I think again by Don Regan who is a former CEO, as you know, of Merrill Lynch, that the objections based on paperwork are really not that valid any more. Everything is computerized, and you just push a button and out comes the information. Is that true in your bank?

Mr. **Bruning**. Well, most of the time. But sometimes it doesn't come out the way it goes in. [Laughter.]

But we understand, or I think that we do, some of the problems of information matching that the Internal Revenue Service has with regard to 1099's, et cetera. I would like to go on record as saying that the American Bankers Association believes that a large portion of the solution to the revenue problem base is collecting those taxes that are going unreported. We would certainly cooperate in any manner with all of our banks to assist the IRS and Treasury in that effort, Senator.

The **Chairman**. Well, we appreciate that. If you will put together the information that Senator Boren asked for, it will be made a part of the record.

Ms. **Sullivan**. Thank you.

The **Chairman**. We will look forward to working with all of you as we put together whatever we put together, if anything.

Yes?

Ms. **Sullivan**. It looks like enforcement is the thing, isn't it?

The **Chairman**. Yes; I think if everybody paid what they should pay we wouldn't be looking for new revenue sources. But that wouldn't mean we wouldn't go back and try to tighten up some areas that should be addressed—completed contract, MODCO, other areas that aren't universally endorsed.

Thank you very much.

Ms. **Sullivan**. Thank you.

Mr. **Cohen**. Thank you.

Mr. **Bruning**. Thank you.

The **Chairman**. They will be followed by Senator Pell. We are pleased to have both of our colleagues before our committee this morning.

Your entire statement will be made a part of the record. You may proceed in any way you wish.

STATEMENT OF HON. CLAIBORNE PELL, A U.S. SENATOR FROM THE STATE OF RHODE ISLAND

Senator PELL. Thank you very much for your kindness in letting me be with you and your courtesy in permitting me to testify. I will abbreviate it and ask that the whole body of the statement be inserted in the record.

I wish to commend the chairman of the committee for your action in publicly announcing and establishing February 19 as the effective date for changes in the safe harbor leasing provisions. I believe this action was necessitated by the very high degree of uncertainty about the future of tax leasing, here in the Senate and throughout the business community nationally. Our own bill, as you know, calls for January 1; but I can see why February 19, 1982, as a question of fairness, might be decided upon.

I think it is apparent to all that the so-called safe harbor leasing provisions are patently offensive and unacceptable to the great majority of taxpaying Americans.

Second, the safe harbor leasing provisions should be repealed because the provisions undermine, I believe, public respect and confidence in our tax laws.

The leasing provisions, in effect, permit a corporation which has excess tax credits to sell those credits or a portion of them to another corporation through a complex paper transaction.

In short, the safe harbor leasing provisions represent a kind of legal dissembling, like calling, perhaps, a turkey a duck—they are both birds, but they are very different. At any time the tax laws dissemble the result is a lowering of public respect and confidence in the intregity and fairness of our tax laws.

The third reason for repeal of the leasing provision is that it is an inefficient and costly way to provide the necessary investment incentives which we all seek. Under the leasing provision the investment tax credits and the depreciation allowances are in effect split between the seller of the tax credits and the buyer of the tax credits; that is, between the so-called lessor and the lessee.

How those tax credits are split is not certain, but it is certain that the lessor corporation receives an economic advantage from the transaction and does so without performing any public service.

Finally, the leasing provision should be repealed because we simply can't afford the revenue loss. With projections of deficits, as you know far better than I, in excess of $100 billion a year in the foreseeable future, the amounts involved here are really too much.

In conclusion let me add, Mr. Chairman, that I fully understand why the leasing provisions were adopted. There are real problems posed by accumulation of excess Federal tax credits by corporations, and those tax credits do pose an inducement for mergers and corporate takeovers. The inability of firms not in their taxable status to use the investment tax credits does place those firms at a disadvantage.

There have been a good many bills offered on this. I think ours is the one with the most cosponsors—a dozen or so. I am delighted to have cosponsored Senator Boren's bill, and he has cosponsored mine, for which I thank him.

The important thing is that we get on with this bill. No matter what the number on the bill is, the important thing is to move ahead with this concept. I congratulate you, Mr. Chairman, on setting up this hearing.

The **Chairman**. Thank you, Senator Pell. We appreciate it very much.

Senator Hatch, we are pleased to have you here this morning.

Senator **Hatch**. I am pleased to be here, Mr. Chairman, and pleased that you are holding these hearings, and I am delighted to see my other brethren up there as well.

STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM THE STATE OF UTAH

Senator **Hatch**. I thank you for this opportunity to testify on what appears to me to be a major policy error in the Economic Recovery Tax Act of 1981.

I supported that bill primarily because it contained the across-the-board tax reductions for individuals that I have advocated and cosponsored for several years. In addition, there were several other provisions of that bill that I think are worthwhile.

These new provisions generally are positive incentives for individuals to save and invest. They are stimulative to the economy, especially in combination with the reductions in spending which were contained in the Omnibus Reconciliation Act of 1981. The President's program supported by Congress can do a great deal to stimulate economic recovery.

Rather than read my complete statement, let me just ask unanimous consent that it be placed in the record in full at this point and just conclude with a statement that once again I want to thank this committee for providing me the opportunity to have my voice heard on this issue.

I urge that the committee support the chairman's amendment to modify the leasing provision effective February 19, and that would be notice to all concerned.

I compliment the chairman for his efforts in this regard.

The **Chairman**. Your statement will be made a part of the record, and we are pleased, as I indicated earlier, to have our colleagues before the committee.

[The prepared statements of Senators Claiborne Pell and Orrin G. Hatch follow:]

STATEMENT BY SENATOR CLAIBORNE PELL, PREPARED FOR DELIVERY BEFORE THE SENATE FINANCE COMMITTEE ON THURSDAY, MARCH 18, 1982.

Mister Chairman and members of the Committee:

Thank you for this opportunity to testify before the Senate Finance Committee. I appear before you today as the Sponsor of S.1896, a bill I introduced on December 1 of last year to repeal the Safe Harbor Leasing Provisions of the Economic Recovery Tax Act of 1981. That legislation, which has been referred to this Committee, is now co-sponsored by 15 members of the Senate. In addition, four members of the Senate have introduced similar or identical bills since the introduction of S. 1896.

At the outset, I wish to commend the chairman of the Committee, Senator Dole, for his action in publicly announcing and establishing February 19, 1982 as the effective date for changes in the Safe Harbor Leasing Provisions. I think that action was necessitated by the very high degree of uncertainty about the future of tax leasing here in the Senate and throughout the business community nationally.

This morning I want to state for the committee very briefly the reason why I believe that Safe Harbor Leasing Provisions should be repealed.

First, I think it is apparent now that the so-called Safe Harbor Leasing Provisions are patently offensive and unacceptable to the great majority of tax-paying American citizens. No matter what economic justification may be offered, the public is just not prepared to see federal tax credits bought and sold on the market place as though the credits were bushels of wheat or sides of beef.

Individual taxpayers know that they are not allowed to buy, sell, loan or lease their individual exemptions, medical deductions or mortgage interest payments and they simply do not understand why American corporations should be allowed to do so.

Secondly, the safe harbor leasing provisions should be repealed because the provisions undermine public respect and confidence in our tax laws. The leasing provisions, in effect, permit a corporation which has excess federal tax credits to sell those tax credits or a portion of them to another corporation, through a complex paper transaction. In the Economic Recovery Tax Act, the Congress provided that those transactions would be called "leases" and would be treated as though they were real leases even though, as the staff report of the Joint Committee on Taxation notes, the transactions "may not bear any resemblance at all to a real lease".

In short, the Safe Harbor Leasing Provisions represent a kind of legal dissembling, like calling a turkey a duck. And any time the tax laws dissemble, the result is a lowering of public respect and confidence in the integrity and fairness of our tax laws.

The third reason for repeal of the leasing provision is that it is an inefficient and costly way to provide investment incentives. Under the leasing provision, the investment tax credits and the depreciation allowances are in effect split between the seller of the tax credits and the buyer of the tax credits--that is between the so-called lessor and lessee. Exactly how those tax credits are split is not certain, but it is absolutely certain that the lessor corporation receives an economic advantage from the transaction and does so without performing any public function that merits a tax break. At the very minimum, the lessor corporation receives an interest-free loan from the Treasury Department for the term of the lease. And as I have noted the lessor corporation does nothing at all to earn that economic advantage.

Finally, the leasing provision should be repealed because we simply can't afford the revenue loss. With projections of budget deficits in excess of 100 billion dollars a year into the foreseeable future, we in the Congress are asked to make very deep cuts in spending for valuable, high priority federal government programs. We are being asked to consider freezing social security payments and veterans pensions. In this kind of severe fiscal crisis, we can not justiy this public trading in corporate tax benefits at a cost of $28 billion during the next five years.

In conclusion, let me say, Mr. Chairman, that I understand fully why the leasing provisions were adopted. There are real problems posed by accumulation of excess federal tax credits by corporations. Those excess tax credits do pose an inducement for mergers and corporate takeovers. The inability of firms not in a taxable status to use the investment tax credits does place those firms at a disadvantage.

Those are real problems caused, it should be noted, by the very large business tax cuts provided by the Economic Recovery Tax Act. The leasing provisions, however, are simply the wrong solution to those problems. There simply must be a better solution than the so-called safe habor leasing provisions.

Mr. Chairman, repeal of the Safe Harbor Leasing Provisions has been endorsed by the National Federation of Independent Businesses and the American Business Conference, both organizations representing dynamic, growth sectors of private industry.

The Safe Harbor Leasing Provisions are beyond reform. Tinkering with the leasing provision will not eliminate the very basic flaws of the provision. I urge the committee to recommend repeal of the Safe Harbor Leasing Provisions.

STATEMENT OF SENATOR ORRIN G. HATCH
BEFORE THE
SENATE FINANCE COMMITTEE
MARCH 18, 1982

MR. CHAIRMAN, THANK YOU FOR THIS OPPORTUNITY TO TESTIFY ON WHAT APPEARS TO ME TO BE A MAJOR POLICY ERROR IN THE ECONOMIC RECOVERY TAX ACT OF 1981. I SUPPORTED THAT BILL PRIMARILY BECAUSE IT CONTAINED THE ACROSS-THE-BOARD TAX REDUCTIONS FOR INDIVIDUALS THAT I HAVE ADVOCATED AND CO-SPONSORED FOR SEVERAL YEARS. IN ADDITION THERE WERE SEVERAL OTHER PROVISIONS OF THAT BILL WHICH I THINK WERE WORTHWHILE. THESE NEW PROVISIONS GENERALLY ARE POSITIVE INCENTIVES FOR INDIVIDUALS TO SAVE AND INVEST. THEY ARE STIMULATIVE TO THE ECONOMY, ESPECIALLY IN COMBINATION WITH THE REDUCTIONS IN SPENDING WHICH WERE CONTAINED IN THE OMNIBUS RECONCILIATION ACT OF 1981. THE PRESIDENT'S PROGRAM, SUPPORTED BY CONGRESS, CAN DO A GREAT DEAL TO STIMULATE ECONOMIC RECOVERY.

LET ME DISCUSS WHAT I THINK IS AN ERROR IN THE BILL WHICH WILL NOT NECESSARILY LEAD TO ECONOMIC EFFICIENCY OR

APPROPRIATELY BRING EQUITY TO OUR TAX SYSTEM. THE NEW "SAFE-HARBOR" LEASING PROVISION OF THE 1981 BILL GUARANTEES THAT CERTAIN TRANSACTIONS WILL BE TREATED AS LEASES, WHICH, IN EFFECT, PERMITS ONE CORPORATION TO BUY THE TAX DEDUCTIONS OF ANOTHER. THIS PROVISION WAS INCLUDED IN THE 1981 LAW TO ACCOMMODATE THE GREATER DEDUCTIONS OF THE ACCELERATED COST RECOVERY SYSTEM FOR FIRMS WHICH WERE UNABLE TO FULLY TAKE ADVANTAGE OF ALL OF THEIR TAX BENEFITS.

I WOULD NOTE HERE THAT THE SAFE-HARBOR PROVISION DID NOT HAVE A COMPLETE AIRING BEFORE THIS COMMITTEE OR THE SENATE BEFORE ITS PASSAGE. THIS IS UNFORTUNATE BECAUSE SOME OF THE UNINTENDED RESULTS NOW COMING TO LIGHT MIGHT HAVE BEEN ANTICIPATED AND AVOIDED. THE CHAIRMAN OF THE COMMITTEE HAS DONE US A SERVICE IN BRINGING TO OUR ATTENTION THE MASSIVE REDUCTION IN CORPORATE TAX LIABILITIES OF CERTAIN COMPANIES AS A RESULT OF THE SAFE-HARBOR PROVISION. GE AND SEVERAL OTHER FIRMS ARE TAKING ADVANTAGE OF THE NEW LAW TO REDUCE THEIR TAX LIABILITY BY MASSIVE PROPORTIONS.

LET ME REVIEW QUICKLY WHAT I THINK IS A MISTAKE IN TERMS OF ECONOMIC EFFICIENCY THAT THE SAFE-HARBOR PROVISION GENERATES. BY PROVIDING THIS TAX BREAK TO UNPROFITABLE COMPANIES, THE TREASURY IS IN EFFECT SUBSIDIZING THOSE COMPANIES, EVEN THOSE THAT ARE INEFFICIENT, ARE PART OF DYING INDUSTRIES, OR FOR ONE REASON OR ANOTHER ARE NO LONGER SERVING THE NEEDS OF THE NATION. IT IS NOT APPROPRIATE FOR THE FEDERAL GOVERNMENT TO ENCOURAGE INEFFICIENT OPERATION IN THE MARKET PLACE, AND YET THIS PROVISION DOES JUST THAT. SINCE FULL CONSIDERATION OF THE NEW SAFE-HARBOR LEASING RULE WAS NOT ACCOMPLISHED BY THE SENATE, I DO NOT KNOW HOW MANY INAPPROPRIATE BAILOUTS ARE BEING ACCOMPLISHED BY THE NEW SAFE-HARBOR LEASING PROVISIONS. ESTIMATES WILL, NO DOUBT, BE AVAILABLE IN THE MONTHS AHEAD AND IT IS AN ISSUE WHICH THIS COMMITTEE MIGHT CARE TO INVESTIGATE.

AS I HAVE ALREADY INDICATED, THE TAX LAWS OF THIS COUNTRY SHOULD ENCOURAGE THE EXPANSION OF THE ECONOMY THROUGH THE STIMULATION OF AGGRESSIVE, HEALTHY FIRMS. UNFORTUNATELY THERE IS LITTLE INDICATION THUS FAR THAT THE JOB-CREATING, INNOVATIVE FIRMS -- MANY NECESSARILY SMALL IN SIZE -- ARE

THE PRIMARY BENEFICIARIES OF THIS PROVISION. SO FAR PRIMARILY THE HEAVILY CAPITALIZED FIRMS ARE THE ONES THAT APPEAR TO BE TAKING GREATEST ADVANTAGE OF THE LEASING RULE.

SOME HAVE ARGUED THAT THERE SHOULD BE TAX ADVANTAGES FOR FIRMS THAT HAVE NO PROFITS, AND WHILE I HAVE ALREADY QUESTIONED THE VALIDITY OF THIS PREMISE, I AM FURTHER WONDERING WHY HEALTHY FIRMS WHICH ALREADY HAVE ACCESS TO SO MANY OTHER TAX BENEFITS SHOULD ALSO BE ALLOWED TO TAKE ADVANTAGE OF THE LEASING PROVISION. I DO NOT BLAME THEM FOR TAKING ADVANTAGE, BUT I DO QUESTION WHETHER CONGRESS SHOULD PERMIT A PROVISION OF THE CODE TO REMAIN ON THE BOOKS WHICH LOSES SO MUCH REVENUE FROM HEALTHY FIRMS IN AN EFFORT TO SUPPORT THE WEAK FIRMS. WHATEVER REASON IS GIVEN TO SUPPORT THIS PROVISION, THE LOGIC AND EFFICACY OF THE MEASURE DO NOT SEEM CREDIBLE.

LET ME TURN TO THE SECOND KEY ISSUE -- THAT OF EQUITY. PERHAPS THE GREATEST FAULT WITH THE SAFE-HARBOR LEASING IS THE PUBLIC PERCEPTION OF THIS PROVISION AS AN UNJUSTIFIED TAX BREAK FOR CORPORATIONS. THIS COMES ABOUT BECAUSE THE LEASING

PROVISION, COMBINED WITH OTHER TAX BENEFITS, IS EFFECTIVELY SO GENEROUS AS TO BRING INTO QUESTION THE FAIRNESS OF THE PROPORTIONATE TAX BURDEN BORNE BY VARIOUS FIRMS THAT HAVE TAKEN ADVANTAGE OF THE LEASING RULE. THE REPORTS OF OTHERWISE HEALTHY CORPORATIONS PAYING A VERY SMALL PERCENTAGE OF THEIR INCOME IN FEDERAL TAXES PAINTS A PICTURE OF A FEW TAKING ADVANTAGE AT THE EXPENSE OF EVERYONE ELSE. THE CONVOLUTED MANNER IN WHICH THE CORPORATE SUBSIDY IS PROVIDED MAKES ONE PAUSE TO ASK WHETHER THE BACK-DOOR METHOD OF THE SUBSIDY RESULTS FROM FEAR OR EMBARASSMENT OF PROVIDING AN UP-FRONT SUBSIDY OF EXACTLY THE SAME AMOUNT. THE REAL QUESTION IS "WOULD SUCH A DIRECT SUBSIDY BE POLITICALLY FEASIBLE?" I THINK NOT. I WOULD BE THE FIRST MEMBER OF THE SENATE TO ENDORSE A FULL-SCALE REVIEW OF THE INTERNAL REVENUE CODE TO ENSURE THAT THE TAX BURDEN ON PRODUCTIVE FIRMS DOES NOT DISCOURAGE THE PRODUCTIVITY OF OUR NATION'S BUSINESS SECTOR. IF INCENTIVES ARE NEEDED, THEN PUBLIC DISCUSSIONS AND CLEAR ANALYSIS

SHOULD BE ENCOURAGED. THE NEW LEASING PROVISION HAD LITTLE OF EITHER BEFORE IT WAS PASSED INTO LAW.

THERE IS ONE POINT THAT I SHOULD MENTION WHERE THE TWO ISSUES I HAVE JUST DISCUSSED OVERLAP -- ONE AREA WHERE EFFICIENCY AND EQUITY ARE RELATED. A NECESSARY QUALITY FOR ANY EFFICIENT TAX SYSTEM TO POSSESS IS A LOW ADMINISTRATIVE COST. IN THE UNITED STATES OUR INTERNAL REVENUE SYSTEM IS ESSENTIALLY SELF-ASSESSING -- AN HONOR SYSTEM IF YOU WILL. IF, HOWEVER, THE TAXPAYERS OF THIS COUNTRY COME TO BELIEVE THAT OUR TAX SYSTEM IS NOT EQUITABLE, THEN A RATIONALIZATION FOR CHEATING THE SYSTEM WILL BE AVAILABLE. NOR WOULD I CARE FOR OUR HONEST TAXPAYERS TO BELIEVE THEY ARE PAYING MORE IN TAXES TO COMPENSATE FOR A CORPORATE SUBSIDY THAT CONGRESS HAD TO SLIP IN THROUGH THE BACK DOOR.

THERE IS ALSO ANOTHER SIDE TO THE PERCEPTION-OF-EQUITY ISSUE. WHILE BOTH THE ADMINISTRATION AND THE CONGRESS ARE SEARCHING FOR SPENDING CUTS AND REVENUE INCREASES TO ACHIEVE

A BALANCED BUDGET IN THE NEAR FUTURE, ONE OF THE POTENTIAL TARGETS FOR REVENUE INCREASES IS THE 5-10-10 ACROSS-THE-BOARD PERSONAL TAX REDUCTIONS WHICH FORMED THE BASIS OF THE PRESIDENT'S PLATFORM AND WERE PUBLICLY SUPPORTED BY MANY MEMBERS OF CONGRESS. I WOULD SORELY HATE TO SEE ANY MODIFICATION OF THAT REDUCTION WHILE THE UNANNOUNCED, BACK-DOOR LEASING PROVISION REMAINS ON THE BOOKS, AT LEAST IN ITS PRESENT FORM.

MR. CHAIRMAN, AS A MEMBER OF THE BUDGET COMMITTEE, I CAN ATTEST THE DIFFICULT PATH BEFORE THE CONGRESS AS IT ATTEMPTS TO REACH A CONSENSUS ON A PROGRAM FOR CONTROLLING THE MASSIVE DEFICITS NOW FORECAST FOR THE NATION. IT WILL NOT BE EASY FOR US AS DECISIONMAKERS TO HAVE TO CHOOSE BETWEEN WHICH PROGRAMS TO HOLD HARMLESS AND WHICH TO REDUCE IN OUR PURSUIT OF A BALANCED BUDGET. BUT I CAN ASSURE YOU THAT NO MEMBER WILL BE ABLE TO EXPECT THE SUPPORT OF HIS OR HER CONSTITUENTS AS BOTH OUTLAY AND TAX EXPENDITURES ARE CUT, IF THIS ALREADY NOTORIOUS TAX LEASING BENEFIT REMAINS UNALTERED.

ONCE AGAIN, I THANK THIS COMMITTEE FOR PROVIDING ME THE OPPORTUNITY TO HAVE MY VOICE HEARD ON THIS ISSUE AND I URGE THAT THE COMMITTEE SUPPORT THE CHAIRMAN'S AMENDMENT TO MODIFY THE LEASING PROVISION EFFECTIVE FEBRUARY 19.

The **Chairman**. Senator Byrd.

Senator **Byrd**. Thank you, Mr. Chairman.

I just wanted to compliment both Senator Pell and Senator Hatch for the fine statement which each of you made to the committee today. I agree with you.

I think this leasing provision poisons an otherwise good tax bill, and I think Congress has an obligation—this committee has an obligation—to either modify or repeal. I am inclined to repeal. But certainly the leasing provision should be substantially modified, if not repealed. I think both of you made fine statements, and I am delighted that you are before the committee today.

I thank you.

Senator **Pell**. Mr. Chairman?

The **Chairman**. Senator Pell.

Senator **Pell**. I would like to request that the text of our bill be inserted in the record with the list of cosponsors we have accrued: Senators Bumpers, Hart, Nunn, Exon, Metzenbaum, Burdick, Pryor, Eagleton, Stennis, Proxmire, Ford, Hollings, Huddleston, Boren, and Biden.

The **Chairman**. And your effective date is January 1?

Senator **Pell**. January 1; yes.

The **Chairman**. It will be included, and the sponsors are noted.

[The text follows:]

97TH CONGRESS
1ST SESSION

S. 1896

To amend the Internal Revenue Code of 1954 to repeal the special leasing provisions enacted by the Economic Recovery Tax Act of 1981.

IN THE SENATE OF THE UNITED STATES

DECEMBER 1 (legislative day, NOVEMBER 30), 1981

Mr. PELL (for himself and Mr. BUMPERS) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to repeal the special leasing provisions enacted by the Economic Recovery Tax Act of 1981.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. REPEAL OF SPECIAL LEASING RULES.

(a) IN GENERAL.—Subsection (f) of section 168 of the Internal Revenue Code of 1954 (relating to accelerated cost recovery system) is amended by striking out paragraph (8) and redesignating paragraphs (9) through (11) as paragraphs (8) through (10), respectively.

(b) CONFORMING AMENDMENTS.—

(1) Paragraph (5) of section 168(f) of such Code (relating to short taxable years) is amended by striking out the last sentence thereof.

(2) Subsection (a) of section 1245 of such Code (relating to gain from disposition of certain depreciable property) is amended by striking out paragraph (6).

SEC. 2. EFFECTIVE DATE.

The amendments made by this Act shall apply to agreements entered into after January 1, 1982.

Senator **Pell**. Thank you.

The **Chairman**. Senator Byrd.

Senator **Byrd**. May I ask, in regard to the effective date, you are not as concerned about that, I assume, as you are about getting some action in regard to the provision. You suggest January 1, Senator Dole suggests February 19, and it could be anywhere along that line; not later, certainly, than whatever date the committee should take up the proposal. I could support any of those dates.

The **Chairman**. Senator Boren?

Senator **Boren**. Mr. Chairman, I just again want to commend both of our colleagues for appearing this morning and for the legislation which they are supporting. We are in full agreement, as they know.

I have also introduced S. 2010, which would repeal this provision. And I think both of you made important points in talking about not only the need for our Tax Code to be fair, in fact, but also to have the perception of fairness as well. When we are talking about asking people to make sacrifices across the country in order to bring our budget deficits in line, it is certainly something that is very much impeded when people pick up the papers and read the kinds of stories they did this week, with one company with $2.6 billion in earnings getting a refund of nearly $100 million in taxes due to the use of this kind of provision. I think it is very, very important that we end this kind of practice so that we can get the cooperation from the people that we are going to have to have in order to get the rest of our budget brought into line. And I commend both of you for your statements.

Senator **Hatch**. I couldn't agree more with what you have just said.

The **Chairman**. I might say the administration has a little different view on leasing. I have heard we have the truly needy and the truly greedy involved. I am not sure where those who benefit from leasing fall but they can't be in the truly needy category.

So I think those who have an interest in leasing should know that it is in some jeopardy, as I look around at different cosponsors across the spectrum.

As to the effective date, my view is that if in fact the Congress feels strongly about doing something, we shouldn't put it off and fritter away a few billion dollars while we are getting around to it. That's why I suggested publicly February 19. It did have some impact on leasing, but I think others have gone ahead as though nothing had happened.

So we appreciate very much your participation.

Senator **Pell**. Thank you.

Senator **Hatch**. Thank you very much, indeed, Mr. Chairman.

The **Chairman**. Gil Thurm, and then Gov. William Winter followed by a panel consisting of Frank Borman, Mr. Jaicks, Mr. Seidman, and Mr. Dickey.

Gil, we are happy to have you before our committee. As a frequent visitor to our committee you know that we read your statement with great care, and if you would put it in the record it would be read with greater care.

You may summarize in any way you wish.

STATEMENT OF GIL THURM, ESQ., VICE PRESIDENT AND LEGISLATIVE COUNSEL, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, D.C.

Mr. THURM. Thank you.

Mr. Chairman and members of this distinguished committee, we appreciate the opportunity to present our views this morning.

Not that long ago, I appeared before this committee on behalf of the 770,000 members of the National Association of Realtors. Shortly after that we appeared on behalf of our 700,000 members. Today, Mr. Chairman, we appear on behalf of our 688,000 members, and that figure is dropping rapidly. We anticipate that we will lose an additional 10 percent of our membership this year.

For 40 months now the housing activity has steadily declined, and this decline has accelerated during the last months to the point where we are immersed in the worst housing depression since the 1930's. More Americans during the last 40 months have lost the opportunity to satisfy their homeowner needs than at any other time in the U.S. history.

Because of the disastrous condition of the housing industry we urge that immediate steps be taken to enable more first-time homebuyers achieve their dreams of home ownership and at the same time help revive housing and the entire economy.

We strongly recommend that Federal spending must be slowed down. The tax-relief plan for July 1983 should be deferred. We encourage this committee to take immediate action to promote housing as the prime hope to lead this Nation out of its worst recession.

Administrative and legislative improvements in operations of tax-exempt State and municipal housing bonds can and should be made now.

A tax credit for first-time homebuyers enabling lowered monthly payments or a down payment and thereby qualifying more families for housing loans should be enacted.

In the alternative, a tax credit for a lender who would then pass this tax credit along to the borrower, in terms of savings on their monthly payments, should also be considered.

With regard to the administration's tax proposals, the National Association of Realtors supports the enactment of a reasonable alternative minimum tax. We believe that all Americans—all individuals and corporations—should pay their fair share of tax, and we would be happy to work with this committee in development of a reasonable alternative minimum tax.

The proposal to impose the construction period interest and tax rule on corporations should be rejected. The members of this committee are well aware that the harsh and discriminatory construction period interest rule was unanimously repealed by the U.S. Senate in 1981 under the leadership of Chairman Dole. And we applaud your efforts in repealing that provision in the U.S. Senate actions. Unfortunately, that compromise provision was dropped in the conference committee action on the Economy Recovery Tax Act. We think it would be a bad mistake to expand an already bad law to apply that law to corporations as well as to individuals.

The construction period interest rule that is now on the books was never subjected to hearings in the House or the Senate; it was never discussed on the House floor or the Senate floor during the deliberations of the Tax Reform Act of 1976; it was added at the last minute in the conference committee action on the Tax Reform Act of 1976, and we never had an opportunity to discuss that provision. It should be repealed.

On withholding of interest and dividends, we applaud the chairman's efforts to try to strengthen reporting requirements rather than impose a withholding requirement.

Mr. CHAIRMAN. We appreciate the opportunity to appear, and we will be happy to respond to any questions the committee may have.

[The prepared statement follows:]

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
regarding
THE ADMINISTRATION'S TAX PROPOSALS
to the
SENATE FINANCE COMMITTEE
by
GIL THURM
March 18, 1982

I am Gil Thurm, Vice President and Legislative Counsel, Government Affairs, of the NATIONAL ASSOCIATION OF REALTORS®.

On behalf of the nearly 700,000 members of the National Association, we greatly appreciate the opportunity to present our views on the impact of federal tax and budget policies on the housing and mortgage markets.

For forty months now, housing activity has steadily declined, and this decline has accelerated during the last 12 months, to the point where we are immersed in the worst housing depression since the 1930s. The Federal government is the primary cause and that is because of:

(1) Record deficits as measured by current dollars, percent of the Gross National Product, or percent of personal or total savings -- which is much higher than any other industrial country (Attachments 1 and 2).

(2) Record borrowing by the Federal government for those deficits.

(3) Record seasonal borrowing from annual rates of $60 billion surplus in the second calendar quarter to $200 billion deficit in the fourth and first quarters which

guarantees wide and harmful seasonal fluctuations in interest rates.

(4) Record taking away of personal and other savings from use by housing and industry.

These events:

(5) Have resulted in record real interest rates, double and triple normal levels and much higher during this Congress and Administration than any other (Attachment 3).

(6) Have caused the loss in the value of every American's home up to 25% and caused the loss in the value of the average American's savings and investment in housing by 50%.

(7) Will completely offset the stimulating effects of last year's tax incentives to invest even though that incentive was small compared to last year's tax incentive to consumers and small companies compared to the proportion of past tax relief measures (Attachment 4).

(8) Will limit recovery to about one-half the normal rate (Attachment 5).

(9) Thus, will provide only modest improvement in our nation's standard of living and a limited increase in jobs during the next three years (Attachment 6).

(10) Will continue to cripple the interest-sensitive sectors of the United States economy, such as small business generally, automobiles, farming, exports and housing and the mature regions of the country, such as the North Eastern and North Central States.

(11) Will lead to greater economic concentration and conglomerate tying arrangements which will likely cause

higher housing costs and less home owner choices in financing and products and other services in the future.

In the case of housing, more Americans during the last 40 months have lost the opportunity to satisfy their home owner needs than at any other time in the United States history, including the drop through the years 1929 to 1933. Home sales have fallen 55 percent (from peak to trough) in dramatic and stark contrast to other real sales in the national economy which have dropped only about 3 percent. About 3-1/2 million households have been denied the opportunity to qualify for adequate housing of their own (Attachment 7).

This loss has occurred while the demographic demand for housing is significantly increasing, not decreasing, even before considering replacement demand (Attachment 8). The loss has not only kept would-be home buyers from achieving their dream of home ownership (Attachment 9), but has caused home owners to lose one half of their life savings and investment. This loss occurred because real interest rates for new mortgages (interest rates after adjusting for inflation) have increased from the normal 3 percent level during the post-war period to an average of 6.9 percent during 1981; 11.5 percent so far in 1982; and 8.2 percent forecast for 1983 (Attachment 2).

The higher real interest rates, rising from 3 percent to 8 percent, has caused a loss of 25 percent of the current marketable value of every American's home (Attachment 18), as well as any other long-lived investment, such as commercial, industrial and agricultural real property. When one considers the average equity of people's homes is 60 percent, this means nearly one-half of the equity of all Americans in their homes has been taken away because of high real interest rates caused by bad economic policy (Attachment 10).

Because of the disastrous condition of and disproportionate share of the economic downturn endured by housing, existing programs should be modified (without adding to the deficit in future years) to enable more first-time home buyers to achieve their dream and at the same time help revive housing and the entire economy.

(1) The tax exempt mortgage bond program should be modified to allow the remaining authorization to be used during the next six months (Attachment 11).

(2) The All Savers Certificates should be folded into the temporary tax credit for first-time home owners (Attachment 11).

Housing serves the nation in three ways as shelter for individuals and families and in the case of families to nurture the next generation; as incentives to save and to invest; and as the best way Americans have devised to disperse real decision making. Home ownership permits households to use the home as they wish, and they have a greater incentive to participate in their community, which fundamentally means much more effective democracy.

These objectives, however, are being thwarted by current policy. During the last three years the proportion of the Gross

National Product for housing has declined from 6 percent to 3 percent (Attachment 12). The proportion of loanable funds going to housing has declined from 45 percent average to less than 25 percent (Attachment 13). Housing supply is failing to meet the underlying demand for new housing during 1979-1981, and is forecast to create an even greater shortage if policies do not change.

RECOMMENDATIONS

The NATIONAL ASSOCIATION OF REALTORS® strongly recommends:

(1) Federal spending must be slowed down (Attachment 20) and be reduced in all parts of the federal budget, including defense, entitlement programs, and other programs. Spending this year has overrun the commitments of the President and the Congress by double the rate compared to the last 10 years. REALTORS® have been responsible and recommended many of the cuts which were subsequently proposed by the President and enacted by the Congress last year and called upon other industries to follow our example (Attachment 14).

(2) Tax relief planned for July 1983 and indexing scheduled for 1985 should be deferred.

(3) Tax increases to discourage consumption but not savings and investment should be considered. REALTORS last year recommended that individual tax relief should be limited to 5 percent across-the-board each year, instead of 10 percent and the tax relief should be no larger than spending reductions to achieve a balanced budget by 1984. (Attachment 15).

(4) Immediate action to promote housing as the prime hope to lead this nation out of its worst recession. This can be achieved by the REALTORS® three-point program which includes only those tax expenditures already included in the President's deficit estimate and which can be easily shifted (Attachment 11 for greater detail).

a. Administrative and legislative improvements in operations of tax-exempt state and municipal housing bond programs should provide as much as another $10 billion for more mortgages, equivalent to helping 500,000 families realize their dream of homeownership, and

b. A tax credit for first-time homebuyers enabling lowered monthly payments or a down payment and thereby qualifying more families for housing loans. The use of existing funds could allow an additional 250,000 families to own their homes, or

c. A tax credit for the lender who would pass along the savings to the buyer. The use of existing funds could allow an additional 250,000 families to own their own homes.

The three-point program is designed to help the would-be first-time homebuyers who are suffering the most by providing for both new and existing homes.

The program should:

a. Be temporary and not add to the President's current deficit estimates.

b. Help to reduce future-year deficits by sunsetting special assistance and help to generate more jobs and income and, thus, tax receipts.

c. Be limited to first-time homeowners (95 percent of whom cannot now qualify for home ownership).

d. Include new and existing homes. Existing home sales stimulate jobs in the fixing up of homes for sale, the transferring and moving, and the remodeling after sale. Additionally, economic activity equal to one-third of the value of the home is generated in the community and directly creates jobs and purchases from local hardware stores, department stores, appliance stores, etc. These effects are realized very quickly. Also, existing homes sales help thrifts and banks increase the interest earnings on assumptions of existing mortgages. Existing home sales and the jobs they create are located in the established parts of the community and do not require local governments, which are suffering from a shortage of funds, to invest in new schools, sewers and roads in the outer fringe of cities. The beneficial impact of a revitalized resale market is geographically widespread and not confirmed to a relatively few growth areas, particularly the South and West, where most construction is concentrated.

(5) Incentives must be provided for housing for the long run -- such as an IRA-type tax-free savings account for first-time home buyers and tax credits for firms and people who invest

in home mortgages. There is a profound need for government policies supporting housing, to continue after appropriate short-term measures, since the traditional government housing policies are being dismantled through the crippling of savings and loans and through high interest rate policies allowing them to invest less and less in home mortgages (Attachment 16).

These recommendations would help return the entire economy to health by helping housing lead the way as it has always done (Attachment 17).

THE ADMINISTRATION'S TAX PROPOSALS

With regard to the Administration's tax proposals, the NATIONAL ASSOCIATION OF REALTORS® provides the following comments:

(1) Alternative Minimum Tax -- the National Association supports the enactment of a reasonable alternative minimum tax rather than an add-on minimum tax. A reasonable alternative minimum tax will help ensure that corporations as well as individuals will pay their fair share of taxes. We would welcome the opportunity to work with this Committee in the development of suggested tax preference items which would be included in an alternative minimum tax.

(2) Construction Period Interest and Taxes -- the proposal to force corporations to amortize over 10 years interest and taxes paid or incurred during the construction period of a non-residential building should be rejected. It is unfair and unwise to apply this harsh rule to construction period interest and tax expenses.

The current rule is only applicable to individuals and partnerships. Extending this rule to corporations only extends the real estate discrimination already in the tax law. We would urge that the construction period interest and tax rule be repealed for all taxpayers rather than applying the rule to corporations. Repeal would merely equalize the treatment of interest and taxes between real estate and all other industries and would also eliminate a disincentive for investors to construct badly-needed residential housing units and productivity-increasing commercial realty.

The U.S. Senate, in 1981, unanimously passed a compromise provision which repealed the discriminatory construction period interest and tax rule for all structures. We applauded the leadership of Chairman Dole and Senators Heinz and Dodd in trying to resolve this matter. Unfortunately, this provision was dropped in the Conference Committee on the Economic Recovery Tax Act of 1981.

We should clearly note that the discriminatory construction period interest and tax rule was never subjected to hearings by the House or Senate, and was never contained in either a House or Senate tax bill. The provision was simply and unfairly added by the Conference Committee on the Tax Reform Act of 1976.

It would be a serious error to compound this problem by broadening the application of a bad law.

(3) Enterprise Zones -- The National Association supports the concept of enterprise zones as a potentially viable framework to foster community revitalization and economic growth. We have

no position on the Administration's proposal inasmuch as the details are not yet available. We are concerned, however, whether the proposal contains a strong housing component as well as industrial and commercial revitalization provisions. Unless a stimulus to both single-family and multi-family housing is provided, the enterprise zone concept will not prove workable because the workers necessary to businesses in the zones will simply not be available.

(4) Withholding on Interest and Dividends -- Rather than impose a withholding tax on interest and dividends, the NATIONAL ASSOCIATION OF REALTORS® supports the concept suggested by Chairman Dole of increased information reporting requirements.

The imposition of withholding on interest and dividends is not needed, is impractical, and would result in a minimal increase in tax revenues, if any, when compared with the additional cost of withholding. In fact, even on a gross revenue basis the Treasury estimates that revenues would increase by only $2.0 billion in the first year. However, since much of this increase is on a one-time basis as a result of the earlier receipt of funds by the Treasury, the long-term effect is substantially less. This small increase is all but overshadowed by the increased cost of implementing a withholding system and, more importantly, the disruption in the marketplace that would come about as a result of withholding. For similar reasons, it would be inappropriate to impose withholding taxes on payments to independent contractors.

ATTACHMENTS

1. Record Deficits.
2. Central Government Deficits in Major Industrial Countries.
3. Record Real Interest Rates.
4. Tax Incentives Offset by Interest Rise.
5. Recovery Limited.
6. March 1982 Forecast Tables.
7. Losses in Housing.
8. Future Demand for Housing.
9. The American Dream of Homeownership.
10. Homeowners Loss in Value of Homes.
11. Housing Assistance.
12. Housing as Share in Gross National Product (GNP).
13. Housing as Share of Loanable Funds.
14. Letter of January 21, 1981, to Other Associations Suggesting They Find Cuts Too.
15. REALTORS® Recommendations on Size of Tax Relief.
16. Federal Housing Credit Programs.
17. Impact of REALTORS® Recommendations:
    - o Fiscal Policy.
    - o Mortgage Bonds Modifications.
    - o Tax Credit For First-time Home Buyers.
    - o Combined Benefits.
18. January 26, 1982 Advertisement.
19. Joint Statement by Members of The Group
20. Spending Overruns Beyond President's Budgets.

ATTACHMENT 1

THE FEDERAL TOTAL DEFICIT AND SAVINGS
($ Billions)

Fiscal Year	Surplus or Deficit(-)			
	Amount	Percent of GNP	Percent of Personal Savings	Percent of Private Savings
1948	12.0	4.9	173.3	35.9
1949	0.6	0.2	5.5	1.4
1950	-3.1	1.2	29.5	7.6
1951	6.1	2.0	51.8	13.9
1952	-1.5	0.4	8.7	2.7
1953	-6.5	1.8	35.9	11.5
1954	-1.2	0.3	6.5	2.1
1955	-3.0	0.8	19.0	4.9
1956	4.1	1.0	21.8	6.1
1957	3.2	0.7	14.2	4.4
1958	-3.0	0.7	13.5	4.1
1959	-12.9	2.7	54.0	16.0
1960	0.3	0.1	1.5	0.4
1961	-3.4	0.7	16.8	4.3
1962	-7.1	1.3	28.8	8.0
1963	-4.8	0.8	22.2	5.3
1964	-6.0	1.0	23.8	6.0
1965	-1.6	0.2	5.2	1.4
1966	-3.8	0.5	10.7	3.0
1967	-8.8	1.1	21.9	6.6
1968	-25.2	3.0	55.2	17.6
1969	3.2	0.4	8.6	2.3
1970	-2.8	0.3	5.8	1.9
1971	-23.0	2.2	37.5	13.5
1972	-23.4	2.1	43.4	12.8
1973	-14.9	1.2	23.3	7.2
1974	-6.1	0.4	7.1	2.6
1975	-53.2	3.6	58.6	21.0
1976	-73.7	4.5	82.0	24.9
1977	-53.6	2.9	74.0	17.3
1978	-59.2	2.8	76.1	17.0
1979	-40.2	1.7	47.6	10.2
1980	-73.8	2.9	76.0	17.4
1981	-78.9	2.8	78.9	17.1
1982 e	-118.3 (131.3) [145.5]	3.8 (4.3) [4.7]	90.3 (100.2) [111.0]	22.9 (25.4) [28.1]
1983 e	-107.2 (137.1) [164.0]	3.1 (4.0) [4.8]	65.4 (83.6) [100.0]	17.5 (22.3) [26.7]
1984 e	-97.2 (144.1) [162.7]	2.6 (3.8) [4.3]	48.5 (71.8) [81.1]	13.6 (20.2) [22.8]

Footnote 1: Figures in parenthesis are based on CBO budget estimates.
Footnote 2: Figures in [ ] are based on REALTORS® budget estimates.

SOURCE: Budget of the United States Government, 1983, Congressional Budget Office, An Analysis of the President's Budgetary Proposals For Fiscal Year 1983 Savings data from the national income accounts and estimates by the NATIONAL ASSOCIATION OF REALTORS®.

ATTACHMENT 2

CENTRAL GOVERNMENT DEFICITS IN MAJOR INDUSTRIAL COUNTRIES

Country	FY1982 Deficit 1/		Real Long-Term Interest Rates
	$US billions	% of Personal Savings in 1982 2/	
United States	118.3 (145.5) 3/	100.2 (111.0)	7-8
Japan	31.8	18.3	2-3
West Germany	23.2	37.8	3.0
France	11.6	19.0	3.0
United Kingdom	15.6	62.5	5

1/ Federal deficit for U.S., general government current account deficits for calendar 1982 for all other countries.

2/ 1982 personal savings figures for all countries other than the U.S. supplied by Wharton Econometric Forecasting Associates.

3/ Figures in parenthesis are REALTOR® estimates.

ATTACHMENT 3

REAL INTEREST RATES IN THE UNITED STATES

Period	Real Long-Term Interest Rates 1/
1950 - 1959 Average	2.04
1960 - 1969 Average	3.41
1970 - 1979 Average	2.23
1980	5.00
1981	6.91
1982 (Forecast)	8.90
1983 (Forecast)	8.20
1984 (Forecast)	8.20

1/ Real long-term interest rates are defined as mortgage rates minus the rate of inflation as measured by the percent change in the GNP deflator.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

ATTACHMENT 4.1

THE COMPARATIVE IMPACT OF THE ECONOMIC RECOVERY TAX ACT AND HIGH INTEREST RATES

In 1981, Congress passed the Economic Recovery Tax Act (ERTA) in an effort to stimulate savings and investment. A major feature of the new tax package directed at boosting investment, was the Accelerated Cost Recovery System under which tax lives for investment in equipment, commercial and industrial buildings and rental housing were reduced and certain tax credits enlarged or enhanced. ERTA also contained many other provisions having stimulative effects on savings and investment, including expansion of IRA and Keogh Plan provisions, reduced maximum tax rates on non-service income, and the All Savers Certificate program.

However, by far the largest component of ERTA in terms of revenue cost was the phased across-the-board reduction in individual income tax rates. While these individual rate reductions provide some modest incentive for savings and investment, most of the impact of these tax rate reductions is reflected in higher consumer spending. In all, almost 75 percent of the ERTA tax cuts are directed primarily at increased consumption and only 25 percent at directly stimulating savings and investment, one of the smallest proportions in the post war period.

Exploding Federal deficits and excessively tight credit growth policies have forced both long- and short-term interest rates to record levels, even after adjusting for inflation. Unfortunately, this has and will continue to offset the impact of ERTA in stimulating investment. As a result the share of both non-residential and housing investment in Gross National Product continues to fall, the very opposite of the intent of ERTA (see Table below).

Share of Investment and Consumption in GNP
(Percent)

	Actual			Forecast		
	Average 1970-79	1980	1981	1982	1983	1984
Private Consumption	62.4	63.2	63.5	65.0	65.0	64.7
Non-Residential Investment	10.4	10.7	10.7	10.5	10.5	10.8
Investment in Housing	4.2	3.2	3.0	2.0	3.3	3.6

ATTACHMENT 4.2

The reasons why high interest rates have more than offset the impact of ERTA on investment are demonstrated. The Accelerated Cost Recovery System, the main investment stimulus in the overall package, increased the rate of return (the incentive to invest) in new non-residential structures by about one percentage point--about the same effect as a one percent drop in long-term borrowing costs (see Table below). For rental housing, the increases in return were slightly larger--around 1.8 percentage points--although this still provided very little incentive for new construction because of the uneconomic return prevailing in the industry before ERTA was passed.

Impact of ERTA on Returns[1/] to New Investment
Holding Period, Years

	5	10	15	20
Non-Residential Construction	+1.0	+0.8	+1.3	+2.5
Rental Housing	+1.9	+1.8	+1.6	+1.3

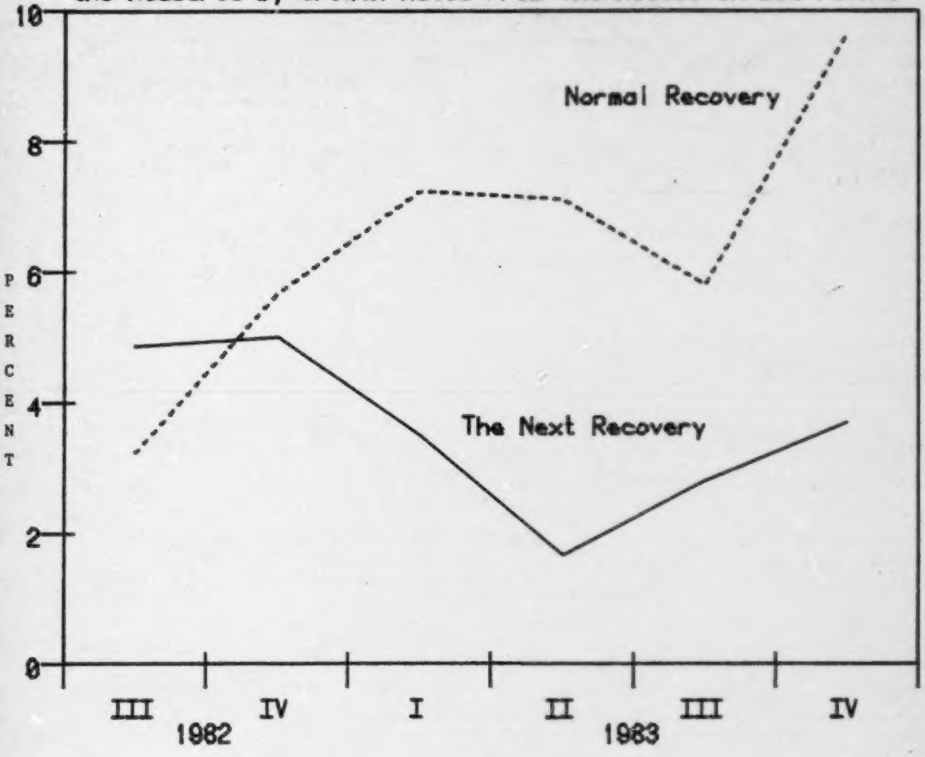
[1/] The effect of a one percentage point increase on after tax returns to investment is approximately equivalent to a one percentage point decrease in interest rates.

Against this, nominal interest rates have risen by almost five percentage points since 1979 and even after adjusting for inflation, are currently more than five percent above normal levels.

This does not imply that the investment incentives in ERTA were inappropriate; on the contrary, they were necessary to stimulate capital formation. However, Congress has the opportunity to enhance the impact of these incentives even more by significantly lowering the Federal deficit, which would allow the Federal Reserve Board to ease its excessively tight credit policies and bring about a sizeable reduction in interest rates.

ATTACHMENT 5

The Next Recovery Will Be Weaker
Than Normal in the Post War Period
(As Measured By Growth Rates From The Recession Low Point)



ATTACHMENT 6.1

Table 1

U.S. ECONOMIC OUTLOOK

MARCH 1982

	QUARTERS							YEARS					
	Actual		Forecast					Actual			Forecast		
	81:3	81:4	82:1	82:2	82:3	82:4	83:1	1979	1980	1981	1982	1983	1984
AGGREGATE ECONOMY													
Gross National Product ($ billions)	2,965	2,995	2,996	3,03[illegible]	3,120	3,226	3,313	2,414	2,626	2,925	3,086	3,433	3,790
Percent Change	11.4	4.2	0.2	[illegible]	11.7	14.0	11.5	14.0	8.8	[illegible]	[illegible]	10.7	[illegible]
Percent Change (without inflation)	1.4	-4.7	-5.4	[illegible]	4.9	5.0	3.5	3.2	-0.2	2.0	-1.5	3.2	3.2
Consumption	3.3	-2.3	0.2	[illegible]	5.7	3.8	3.3	2.9	0.5	2.5	0.9	3.1	2.7
Durables	8.6	-18.8	7.5	-3.3	20.5	10.3	6.2	0.2	-7.4	2.6	0.2	5.9	3.9
Nondurables	2.1	-0.7	-1.8	-0.6	1.3	2.0	2.8	2.6	1.1	2.5	0.0	2.0	1.8
Services	2.6	1.9	-0.2	1.0	3.7	3.6	3.6	4.1	2.6	2.6	1.8	3.2	3.1
Residential Investment	-36.3	-28.2	-8.5	19.5	36.7	49.5	19.6	-5.2	-18.6	-6.1	-5.9	19.6	11.8
Nonresidential Investment	7.1	-5.3	-11.6	-4.3	0.7	3.1	4.5	6.5	-3.0	2.4	-4.0	3.5	5.7
Structures	8.4	4.5	-10.0	[illegible]	-9.1	-6.6	0.4	8.7	-0.1	5.1	-4.3	-2.1	3.1
Equipment	6.3	-9.2	-12.5	[illegible]	5.5	7.7	6.4	5.5	-4.2	1.2	-3.8	6.0	6.8
Exports	-3.4	-13.9	-3.5	1.1	2.8	3.5	4.7	15.2	9.6	-0.9	-3.5	4.2	4.8
Imports	5.3	-0.7	-1.1	1.6	6.4	9.0	7.4	6.0	-0.1	5.5	2.7	6.3	4.6
Government Purchases	[illegible]	10.5	-7.5	-2.2	-1.2	-1.0	0.0	1.5	2.9	0.6	-1.3	-0.5	0.5
Consumption (% of GNP)	63.5	63.9	64.8	65.1	65.2	65.0	65.0	62.8	63.2	63.5	65.0	65.0	64.7
Residential Investment (% of GNP)	2.8	2.6	2.4	2.7	2.9	3.2	3.3	4.0	3.2	3.0	2.9	3.3	3.6
Nonresidential Investment (% of GNP)	10.8	10.8	10.6	10.5	10.4	10.4	10.4	11.0	10.7	10.7	10.5	10.5	10.8
Inventory Change ($ billions)	27.5	12.6	-4.9	-11.1	-0.1	6.1	9.9	17.5	-5.9	17.0	-4.0	11.3	18.5
Mfg. Capacity Utilization Rate (%)	79	75	70	71	73	75	76	86	79	78	72	76	77
Auto Sales (millions of units)	9.1	7.4	8.2	7.6	8.8	8.8	9.0	10.6	9.0	8.6	8.4	8.9	9.3
Manufacturing Industrial Production (% change)	0.3	-18.2	-20.9	2.4	13.8	13.0	7.7	4.4	-4.5	2.5	-5.4	7.4	4.8
Common Market	-2.6	4.4	1.8	3.1	4.3	4.3	3.3	4.7	0.2	-2.2	2.2	3.1	2.3
Japan	6.0	11.9	3.1	4.5	2.8	5.6	8.4	8.2	6.8	3.1	5.2	5.2	3.1
Employment (millions)	100.7	100.0	99.3	99.4	99.9	100.5	101.1	98.8	99.3	100.4	[illegible]	102.3	105.2
Unemployment Rate (%)	7.4	8.4	8.8	9.2	9.2	9.1	9.0	5.9	7.2	7.6	9.1	8.7	8.0
Disposable Income per Household (average)	26,349	26,878	27,153	27,559	28,523	29,217	29,876	21,565	23,748	26,040	28,113	30,923	33,656
Percent Change — Year Ago (w/o inflation)	1.5	1.1	0.3	0.3	1.8	2.4	3.2	2.2	-0.1	1.2	1.2	3.0	2.1
Total Taxes per Household (average)	13,651	13,503	13,350	13,515	13,400	13,702	13,986	11,106	12,057	13,469	13,534	14,122	15,050
Percent Change — Year Ago	13.0	6.4	0.1	1.0	-1.2	2.1	4.7	10.5	8.6	11.7	0.5	[illegible]	6.6
Percent of Disposable Income	51.8	50.2	49.2	49.0	47.3	47.2	46.8	51.5	50.8	51.7	48.2	45.7	44.7
Household Debt as Percent of Disposable Income	77.6	77.1	77.3	77.1	75.5	75.2	75.2	80.2	79.4	[illegible]	76.2	[illegible]	[illegible]
Consumer Price Inflation (CPI)	11.8	7.8	4.3	6.0	7.1	8.2	9.1	11.3	13.5	10.3	7.0	8.3	8.5
Gross National Product Inflation (GNP Deflator)	9.9	9.3	5.8	6.5	6.5	8.5	7.8	8.5	9.0	9.2	7.4	7.5	7.0
Personal Consumption Inflation	9.1	7.8	5.5	5.8	6.1	7.1	7.6	8.9	10.2	8.3	6.7	6.8	6.6
Residential Construction Inflation	7.1	6.4	8.9	6.8	8.7	10.2	10.3	12.8	9.4	6.9	7.7	9.6	8.9
Nonresidential Construction Inflation	8.6	10.7	9.1	8.1	8.9	10.3	10.9	12.6	13.4	9.5	9.5	10.0	8.8
Producers Price Inflation (PPI)	4.7	0.6	2.6	6.2	7.2	9.4	9.3	12.5	14.1	9.1	6.2	8.2	8.5
Compensation per Manhour (% change)	9.6	6.5	9.0	7.8	7.8	8.4	8.9	9.7	9.9	10.0	8.2	8.4	8.9
Productivity (% change)	-2.0	-7.4	-3.8	0.4	4.5	3.1	2.5	-0.7	-0.3	0.8	-1.7	2.4	1.6
Unit Labor Cost (% change)	11.5	15.0	13.3	7.4	3.2	5.1	6.2	10.4	10.3	9.1	10.1	5.8	7.1
Unit Capital Cost (% change)	9.5	8.8	8.3	8.0	7.7	7.5	7.3	11.3	11.3	9.8	7.9	7.6	8.1
Before Tax Corporate Profits ($ billions)<1>	283	227	206	203	218	235	245	255	258	239	215	253	284
Corporate Tax Liability	78	67	58	57	63	69	70	88	82	77	61	73	79
'Windfall Profits' Tax Receipts	29	26	26	24	25	26	24	0	13	29	25	23	26
Inventory Valuation Adjustment	-25	-22	-10	-15	-17	-21	-25	-43	-46	-28	-16	-24	-36
Capital Consumption Adjustment	-13	-13	-10	-7	-6	-7	2	-16	-17	-16	-6	3	5
After Tax Profits	156	136	122	122	131	140	151	168	163	153	129	157	179
Profits from Current Production (with IVA, CCA)	118	99	103	100	109	118	128	109	100	112	107	136	146
Adjusted for Inflation (81:3 base)	118	97	99	95	102	108	115	131	111	113	101	119	121
Percent Change - Year Ago	8.3	-6.8	-17.5	-18.9	-13.3	11.2	16.5	-1.6	-15.7	1.8	-10.6	17.8	1.7
Per Unit of Output (% of GNP)	4.0	3.3	3.4	3.3	3.5	3.7	3.9	4.5	3.8	3.8	3.5	4.0	3.9
Effective Corporate Tax Rate (%)<1>	41	41	37	37	38	38	36	45	45	41	38	36	36
Federal Tax Receipts (Unified basis)	627	589	524	720	585	567	571	481	533	623	599	648	710
Federal Expenditures (Unified basis)	661	782	709	722	706	770	788	509	601	695	727	799	853
Surplus or Deficit (Unified basis)	-34	-193	-185	-2	-122	-203	-217	-28	-68	-73	-128	-151	-144
% of GNP	-1.2	-6.4	-6.2	-0.1	-3.9	-6.3	-6.5	-1.2	-2.6	-2.5	-4.1	-4.4	-3.8

<1> Adjusted to include impact of windfall profits tax on domestic crude oil production.

Source: Model developed by the NATIONAL ASSOCIATION OF REALTORS, and Data Resources, Inc.
Assumptions and simulations by Dr. Jack Carlson, Hugh Graham, Kenneth Kerin, and Glenn Crellin.

ATTACHMENT 6.2

Table 1

REAL ESTATE AND FINANCIAL MARKETS

MARCH 1982

	QUARTERS							YEARS					
	Actual		Forecast					Actual			Forecast		
	81:3	81:4	82:1	82:2	82:3	82:4	83:1	1979	1980	1981	1982	1983	1984
REAL ESTATE MARKETS													
Existing Single-Family Home Sales (thousands)	2,253	1,923	1,983	2,137	2,489	2,837	2,973	3,701	2,881	2,351	2,361	3,185	3,675
Percent Change - Year Ago	-25.7	-34.6	-23.8	-18.8	10.5	47.5	50.1	-4.2	-22.2	-18.4	0.4	34.9	15.4
Dollar Volume (billions)	179.7	149.2	155.0	172.2	207.3	233.3	249.4	237.6	209.7	184.1	191.9	280.0	340.4
Existing Home Prices - Median ($1000's)	67.6	66.2	67.2	69.6	72.2	71.5	73.2	55.7	62.2	66.4	70.1	76.7	85.9
Percent Change - Year Ago	6.9	4.5	4.5	4.8	6.9	8.1	8.9	14.4	11.7	6.8	6.1	9.4	12.0
Monthly Mortgage Payment (P&I, 80%, 30 yr.)	788	795	780	753	737	780	820	433	580	742	768	833	936
Percent of Household Income	30	30	29	28	27	27	28	20	23	29	28	28	29
New Single-Family Home Sales (thousands)	360	397	374	461	535	512	506	709	530	426	471	589	615
Percent Change - Year Ago	-40.2	-20.6	-26.6	3.9	48.9	28.8	35.2	-13.7	-24.5	-19.5	10.0	25.1	4.5
New Home Prices - Median ($1000's)	69.8	70.0	71.2	72.5	74.2	76.3	78.5	62.9	64.5	68.8	73.5	81.7	90.4
Percent Change - Year Ago	6.2	5.2	5.9	3.0	6.3	9.0	10.2	12.9	2.5	6.7	6.6	11.1	10.5
New Home Prices--Mean ($1000's, Quality Adjusted)	83.9	88.7	90.2	92.6	93.4	96.5	98.4	71.6	78.5	85.3	92.7	101.2	110.2
Percent Change - Year Ago	7.4	8.0	8.3	8.6	8.7	9.0	9.1	16.8	10.1	8.6	8.6	9.2	8.9
New Mortgage Commitments ($ billions)	67.9	62.5	65.6	61.9	87.3	86.2	80.9	129.0	87.1	59.5	70.2	69.1	112.9
Percent Change - Year Ago	-50.3	-55.6	-41.6	-10.8	82.1	102.8	77.3	-8.8	-32.5	-31.7	18.0	-1.7	63.5
Mortgage Debt Outstanding ($ billions)	1,525	1,555	1,589	1,622	1,660	1,696	1,729	1,286	1,401	1,512	1,642	1,788	1,948
Homeowners' Equity ($ billions)	2,946	2,984	3,028	3,085	3,114	3,190	3,280	2,611	2,750	2,913	3,099	3,439	3,880
Housing Inventory (millions)	84.6	84.7	84.8	84.8	84.9	85.1	85.3	82.0	83.0	84.5	84.9	85.6	86.4
Private Housing Starts (thousands)	962	871	899	986	1,189	1,363	1,316	1,745	1,292	1,085	1,109	1,374	1,629
Single-Family	644	540	602	650	822	974	909	1,194	852	706	762	944	1,178
Multi-Family	317	331	297	336	367	389	406	551	440	379	347	430	451
Subsidized	98	104	136	143	136	113	75	173	173	104	132	52	10
Mobile Home Shipments (thousands)	246	207	192	186	204	210	225	270	223	240	199	221	216
Rental Vacancy Rate (%)	5.0	5.0	5.0	4.9	4.8	4.8	4.7	5.4	5.4	5.0	4.9	4.7	4.5
Unsold New Homes (% of sales)	88.9	75.3	79.3	78.2	73.5	67.4	63.1	59.5	70.2	76.1	74.6	64.5	70.8
Office Vacancy Rate (%)<1>	4.6	4.8	5.0	5.0	4.9	4.9	4.8	4.4	3.7	4.3	5.0	4.6	4.2
Industrial Vacancy Rate (%)<1>	3.7	3.8	4.0	4.1	4.2	4.4	4.3	3.0	3.5	3.7	4.2	4.3	3.9
New Commercial Building Construction (% Ch Value)	12.3	0.5	-3.4	0.2	-1.7	2.6	14.0	33.8	21.7	11.1	0.3	10.3	14.9
New Industrial Building Construction (% Ch Value)	68.3	2.8	-17.9	-36.2	13.6	17.5	29.0	37.2	-6.7	20.5	-3.1	21.6	35.4
FINANCIAL MARKETS													
Personal Savings Rate (%)	5.2	6.1	5.9	6.2	7.0	7.0	6.9	5.3	5.6	5.3	6.5	7.4	8.0
Money Supply (M1b) (% change)	0.2	5.9	9.0	1.4	6.4	3.4	4.5	7.8	6.2	6.7	5.2	4.2	6.1
Money Supply (M2) (% change)	8.6	9.1	14.8	3.0	6.8	9.6	8.7	8.9	8.7	9.1	9.6	8.8	11.3
Total Time and Savings Deposits (% change)	6.7	6.2	7.1	9.2	9.7	9.2	9.2	8.6	7.5	8.7	7.6	8.9	7.6
Selected Interest Rates (Percent)													
New Home Mortgage Commitment Rate	17.35	17.95	17.31	16.10	15.58	16.23	16.60	11.27	14.00	16.71	16.30	16.16	16.22
'People-to-People' Mortgage Rate	13.00	12.00	12.50	12.10	12.30	12.50	12.70	[illegible]	11.25	13.15	12.35	11.90	11.70
Corporate Bond Rate (AAA)	14.92	14.62	14.81	14.43	13.94	14.12	14.26	9.63	11.94	14.17	14.32	14.17	14.25
Government Bond Rate	15.61	14.11	14.39	12.45	12.30	13.11	13.56	9.62	11.51	14.34	13.06	13.37	13.15
Federal Funds Rate	17.58	13.59	14.70	12.32	12.76	14.33	15.18	11.19	13.36	16.38	13.33	15.87	14.76
3 Month Treasury Bills	15.05	11.75	13.40	11.28	11.67	12.79	13.47	10.07	11.43	14.03	12.28	14.02	13.32
1 Year Treasury Bills	16.32	13.35	14.77	12.39	12.56	13.31	13.79	10.67	12.05	14.78	13.26	14.07	13.64
Commercial Paper Rate	16.77	13.04	14.06	11.88	12.42	14.21	15.12	10.97	12.66	15.33	13.16	[illegible]	14.43
Rate on Money Market Fund Shares	17.21	13.31	14.62	12.13	12.67	14.50	15.63	11.12	12.89	15.68	13.63	[illegible]	14.71
Prime Rate	20.32	7.01	16.79	14.93	15.25	16.82	17.18	12.67	15.27	18.87	15.95	17.15	15.78

<1> Historical data courtesy of Coldwell Banker.

Source: Model developed by the NATIONAL ASSOCIATION OF REALTORS, and Data Resources, Inc.
Assumptions and simulations by Dr. Jack Carlson, Hugh Graham, Kenneth Rosen, and Glenn Crellin.

ATTACHMENT 7

COMPONENTS OF LOST GNP ATTRIBUTABLE TO THE DECLINE IN REAL ESTATE ACTIVITY

(Billion)

Expenditure Category	1979	1980	1981	Aggregate 3-Year Total
Single family sales & construction	$3.7	$38.5	$58.8	$101.0
Single family construction	1.1	24.0	33.5	58.6
Expenditures before resales	.2	.9	1.6	2.7
Expenditures at the time of sale	2.0	10.5	17.9	30.4
Expenditures after sale	.4	2.6	4.2	7.2
Lender's income net of cost of funds	.1	.5	1.5	2.1
Mortgage insurers' income	.	.	.1	.1
Multifamily construction	5.6	8.9	11.4	25.9
Manufactured Housing production	.2	1.4	1.5	3.1
Commercial and industrial construction	1.5	9.5	12.5	23.5
All other private construction	1.2	2.5	8.2	11.9
Multiplier effects	6.1	30.4	46.2	82.7
Total	$18.4	$91.2	$138.6	$248.2

. Less than $.05 Billion.

ATTACHMENT 8.1

UNITED STATES
LONG TERM HOUSING OUTLOOK 1980 - 1990

Average Annual Growth Rates in the Demographic Demand for Housing
By Tenure And By Structure Type
(excludes replacement demand)
(percent)

	10 YEAR INTERVALS				5 YEAR INTERVALS			
	ACTUAL			FORECAST	ACTUAL		FORECAST	
	Previous Decades			Next Decade	Previous 5 Years		Next 5 Years	
Structure Type	1950 to 1960	1960 to 1970	1970 to 1980	1980 to 1990	1970 to 1975	1975 to 1980	1980 to 1985	1985 to 1990
ALL OCCUPIED UNITS	2.2	2.8	2.4	1.7	2.7	2.2	1.7	1.6
OWNER OCCUPIED	3.4	2.0	3.2	2.0	3.3	3.2	2.3	1.6
Single Unit	3.7	1.7	3.1	1.9	3.1	3.2	2.2	1.6
Multi Unit	-1.7	2.0	2.1	3.0	0.7	3.4	3.7	2.4
Mobile Homes	10.5	10.0	6.6	1.8	10.0	3.4	1.9	1.7
RENTER OCCUPIED	0.5	1.5	0.9	1.0	1.7	0.1	0.5	1.4
Single Unit	1.3	-1.3	-1.0	1.3	-0.2	-1.7	1.1	1.4
Multi Unit	-0.2	3.5	1.7	0.8	2.6	0.9	0.2	1.4
Mobile Homes	3.3	13.6	6.5	1.3	10.1	2.9	1.1	1.6

1/ This is a forecast of the potential demographic demand for housing and is based on Series II state population projections by the Bureau of the Census, and unpublished data from the Annual Housing Survey and the Current Population Survey.

2/ The figure for 1980 was estimated based on national data from the Bureau of the Census, "Household and Family Characteristics: March 1980", Series P-20, No. 366, Table #24, September 1981; and "Households and Families, By Type: March 1981 (Advance Report)", Series P-20, No. 367, Table #4, October 1981.

SOURCE: NATIONAL ASSOCIATION OF REALTORS. Actual data from the 1950, 1960, and 1970 Censuses of Housing; 1975 Annual Housing Survey; and the 1980 Current Population Survey.

ATTACHMENT 8.2

LONG TERM HOUSING OUTLOOK 1980 - 2000
Average Annual Growth Rate In The Demographic Demand For Housing
For All Occupied Housing Units, By Region And By State
(excludes replacement demand) (percent)

	10 YEAR INTERVAL					5 YEAR INTERVAL			
	ACTUAL			FORECAST		FORECAST			
	1950 to 1960	1960 to 1970	1970 to 1980	1980 to 1990	1990 to 2000	1980 to 1985	1985 to 1990	1990 to 1995	1995 to 2000
UNITED STATES	2.2	1.8	2.4	1.7	1.1	1.7	1.6	1.2	1.0
NORTH EAST	1.9	1.4	1.4	1.1	.7	1.1	1.0	.7	.6
Connecticut	2.8	2.2	1.6	1.1	.6	1.2	1.0	.7	.5
Maine	1.0	.8	2.4	2.1	1.6	2.2	2.1	1.6	1.5
Massachusetts	1.0	1.4	1.5	1.4	.3	1.5	[illegible]	[illegible]	[illegible]
New Hampshire	1.5	2.3	2.9	2.2	1.6	2.3	2.1	1.7	1.4
New Jersey	2.8	2.1	1.6	1.2	.8	1.3	1.2	.7	.9
New York	2.0	1.2	1.2	.8	.5	.8	.8	.6	.5
Pennsylvania	1.4	1.0	1.2	.9	.5	1.0	.9	.6	.4
Rhode Island	1.3	1.3	1.2	1.3	.9	1.4	1.3	1.0	.9
Vermont	.7	1.8	2.3	1.8	1.2	1.8	1.7	1.3	1.1
NORTH CENTRAL	1.7	1.3	2.0	1.2	.7	1.2	1.1	.8	.6
Illinois	1.8	1.3	1.6	.9	.5	1.0	.9	.6	.5
Indiana	1.7	1.5	2.0	1.2	.7	1.2	1.1	.7	.6
Iowa	.8	.6	2.0	1.2	.8	1.3	1.1	.9	.7
Kansas	1.4	.8	2.0	1.2	.8	1.3	1.2	.8	.7
Michigan	2.3	1.7	2.3	1.3	.7	1.4	1.2	.8	.6
Minnesota	1.6	1.3	2.5	1.5	.9	1.6	1.4	1.0	.8
Missouri	1.3	1.1	1.8	1.2	.8	1.3	1.2	.8	.8
Nebraska	1.0	.9	2.3	1.6	1.0	1.6	1.5	1.1	1.0
North Dakota	.7	.5	2.9	1.4	.9	1.5	1.3	.9	.9
Ohio	2.1	1.4	1.8	.9	.4	1.0	.8	.5	.3
South Dakota	.6	.3	2.6	1.3	.8	1.4	1.2	.8	.8
Wisconsin	1.7	1.5	2.8	1.7	1.1	1.8	1.6	1.2	.9
SOUTH	2.1	2.2	3.1	2.2	1.6	2.3	2.1	1.6	1.5
Alabama	1.2	1.6	2.6	1.8	1.2	1.9	1.7	1.3	1.2
Arkansas	-.0	1.6	2.9	1.9	1.4	2.0	1.9	1.4	1.3
Delaware	3.6	2.5	2.6	1.6	1.0	1.7	1.5	1.1	.9
D.C.	1.2	.4	-.7	.1	-.0	.1	.2	-.1	.0
Florida	6.6	4.0	5.1	3.3	2.2	3.6	3.0	2.3	2.0
Georgia	1.9	2.5	3.0	2.3	1.7	2.3	2.2	1.8	1.6
Kentucky	.9	1.4	2.6	1.9	1.3	1.9	1.8	1.4	1.3
Louisiana	2.1	1.7	2.4	1.6	1.1	1.7	1.6	1.2	1.0
Maryland	3.0	3.1	2.8	2.0	1.4	2.0	1.9	1.5	1.3
Mississippi	.2	1.1	2.6	1.7	1.2	1.7	1.6	1.3	1.2
North Carolina	1.9	2.3	3.2	2.1	1.5	2.2	2.1	1.6	1.4
Oklahoma	1.0	1.5	2.2	1.8	1.2	1.8	1.7	1.3	1.2
South Carolina	1.6	2.0	3.6	2.4	1.7	2.5	2.3	1.8	1.6
Tennessee	1.4	1.9	2.8	1.8	1.3	1.9	1.7	1.3	1.2
Texas	2.4	2.1	3.0	2.3	1.6	2.3	2.2	1.7	1.6
Virginia	2.4	2.6	3.2	2.1	1.5	2.2	2.1	1.6	1.4
West Virginia	.1	.5	2.4	1.5	1.0	1.6	1.4	1.1	1.0
WEST	3.7	2.6	3.2	2.0	1.3	2.1	1.9	1.4	1.2
Alaska	N/A	3.3	5.2	2.2	1.5	2.4	2.1	1.6	1.4
Arizona	5.7	3.9	5.9	3.3	2.1	3.6	3.0	2.3	1.9
California	4.1	2.8	2.7	1.8	1.1	1.9	1.7	1.2	1.1
Colorado	3.1	2.7	4.2	2.8	1.8	3.0	2.6	1.9	1.7
Hawaii	N/A	2.9	5.3	2.2	1.5	2.4	2.1	1.6	1.3
Idaho	1.4	1.2	4.3	2.6	1.8	2.8	2.4	1.9	1.7
Montana	1.4	.7	3.4	2.1	1.4	2.3	1.9	1.4	1.3
Nevada	6.2	5.7	4.7	2.7	1.8	2.9	2.5	1.9	1.6
New Mexico	3.6	1.4	4.3	2.6	1.7	2.8	2.4	1.8	1.6
Oregon	1.5	2.2	3.4	2.0	1.4	2.2	1.9	1.4	1.3
Utah	2.5	2.1	3.9	2.5	1.8	2.7	2.4	1.9	1.8
Washington	2.0	2.1	2.4	1.3	.8	1.3	1.2	.9	.7
Wyoming	1.7	.5	4.1	2.5	1.6	2.7	2.3	1.7	1.5

N/A = Not Available

1/ This is a forecast of potential demographic demand for housing and is based on Series II State population projections by the Bureau of the Census, and unpublished data from the Annual Housing Survey and the Current Population Survey.

2/ A housing unit is occupied if a person or group of persons is living in it at the time of the survey or if the occupants are only temporarily absent; for example, on vacation. A housing unit is "owner occupied" if the owner or co-owner lives in the unit, even if it is mortgaged or not fully paid for. All other occupied units are "renter occupied."

SOURCE: NATIONAL ASSOCIATION OF REALTORS®. Actual data from the 1950, 1960, and 1970 Censuses of Housing; 1975 Annual Housing Survey; and the 1980 Current Population Survey.

ATTACHMENT 8.3

UNITED STATES
LONG TERM HOUSING OUTLOOK 1980 - 1990
Increase in the Demographic Demand for Housing
By Tenure And By Structure Type
(excludes replacement demand)
(millions)

	10 YEAR INTERVALS				5 YEAR INTERVALS			
	ACTUAL			FORECAST	ACTUAL		FORECAST	
	Previous Decades			Next Decade	Previous 5 Years		Next 5 Years	
Structure Type	1950 to 1960	1960 to 1970	1970 to 1980	1980 to 1990	1970 to 1975	1975 to 1980	1980 to 1985	1985 to 1990
ALL OCCUPIED UNITS	10.2	10.4	17.2	14.4	9.1	8.2	7.2	7.2
OWNER OCCUPIED	9.2	7.1	15.0	11.8	7.0	8.0	6.5	5.2
Single Unit	9.2	5.5	12.8	10.0	5.8	7.0	5.6	4.4
Multi Unit	-0.4	0.5	0.6	1.1	0.1	0.5	0.6	0.5
Mobile Homes	0.4	1.1	1.6	0.7	1.1	0.5	0.3	0.3
RENTER OCCUPIED	1.0	3.3	2.3	2.6	2.1	0.2	0.7	2.0
Single Unit	1.1	-1.2	-0.8	1.0	-0.1	-0.7	0.4	0.6
Multi Unit	-0.2	4.3	2.8	1.5	2.0	0.8	0.2	1.3
Mobile Homes	na	0.2	0.3	0.1	0.2	0.1	na	0.1

na = less than 100,000

1/ This is a forecast of the potential demographic demand for housing and is based on Series II state population projections by the Bureau of the Census, and unpublished data from the Annual Housing Survey and the Current Population Survey.

2/ The figure for 1980 was estimated based on national data from the Bureau of the Census, "Household and Family Characteristics: March 1980", Series P-20, No. 366, Table #24, September 1981; and "Households and Families, By Type: March 1981 (Advance Report)", Series P-20, No. 367, Table #4, October 1981.

SOURCE: NATIONAL ASSOCIATION OF REALTORS. Actual data from the 1950, 1960, and 1970 Censuses of Housing; 1975 Annual Housing Survey; and the 1980 Current Population Survey.

ATTACHMENT 8.4

LONG TERM HOUSING OUTLOOK 1980 - 2000
Increase In The Demographic Demand For Housing
For All Occupied Housing Units, By Region And By State
(excludes replacement demand) (thousands)

	10 YEAR INTERVAL					5 YEAR INTERVAL			
	ACTUAL			FORECAST		FORECAST			
	1950 to 1960	1960 to 1970	1970 to 1980	1980 to 1990	1990 to 2000	1980 to 1985	1985 to 1990	1990 to 1995	1995 to 2000
UNITED STATES	10,198	10,422	17,242	14,418	11,129	7,229	7,189	5,778	5,351
NORTH EAST	2,295	1,961	2,282	1,979	1,346	1,009	970	710	636
Connecticut	184	178	164	127	70	67	60	40	30
Maine	27	22	79	90	79	44	46	39	40
Massachusetts	229	226	288	316	229	160	156	125	104
[illegible]	[illegible]	44	73	75	61	36	39	31	30
New Jersey	433	411	375	339	247	169	170	[illegible]	[illegible]
New York	923	665	761	550	377	277	273	201	176
Pennsylvania	435	356	468	407	220	217	190	129	91
Rhode Island	31	35	39	48	37	23	25	18	19
Vermont	9	22	33	31	26	16	15	13	13
NORTH CENTRAL	2,407	2,137	3,900	2,678	1,723	1,370	1,308	930	793
Illinois	503	417	610	401	248	201	200	131	117
Indiana	218	223	346	235	152	121	114	[illegible]	71
Iowa	62	54	200	137	101	72	65	55	46
Kansas	85	55	156	116	78	59	55	39	39
Michigan	454	409	662	447	280	231	216	155	125
Minnesota	149	160	328	242	160	123	119	86	74
Missouri	163	160	294	235	166	117	118	85	81
Nebraska	39	41	122	100	78	51	49	39	39
North Dakota	12	6	61	37	26	20	17	14	12
Ohio	539	436	634	368	183	195	173	108	75
South Dakota	14	6	56	35	25	20	15	14	11
Wisconsin	179	182	431	323	[illegible]	163	160	122	106
SOUTH	2,869	3,733	6,899	6,347	5,406	3,135	3,212	2,736	2,650
Alabama	97	149	301	258	208	129	129	107	101
Arkansas	-2	90	205	174	145	87	87	73	72
Delaware	37	36	50	36	26	18	16	16	10
D.C.	26	12	-20	1	2	0	1	1	1
Florida	729	736	1,481	1,44[illegible]	1,245	726	718	638	607
Georgia	181	299	461	[illegible]	413	224	236	208	205
Kentucky	72	132	291	258	217	127	131	111	106
Louisiana	170	158	281	236	181	116	120	93	88
Maryland	223	311	379	337	280	165	172	146	134
Mississippi	13	70	182	149	125	74	75	64	61
North Carolina	211	304	555	485	412	240	245	212	200
Oklahoma	73	114	207	202	171	101	101	86	85
South Carolina	93	130	306	279	247	136	143	124	123
Tennessee	133	210	379	313	256	156	157	132	124
Texas	588	656	1,179	1,158	1,024	566	592	512	512
Virginia	228	319	507	452	371	223	229	191	180
West Virginia	3	25	146	110	89	56	54	45	44
WEST	2,625	2,549	4,162	3,413	2,654	1,716	1,697	1,382	1,272
Alaska	59	21	52	32	28	15	17	14	14
Arizona	157	172	416	369	307	186	183	158	149
California	1,649	1,588	1,990	1,658	1,234	833	825	650	584
Colorado	140	160	351	327	267	164	163	138	129
Hawai'	153	51	139	83	67	42	41	35	32
Idaho	25	25	115	96	82	49	47	61	41
Montana	26	14	86	69	55	34	35	28	27
Nevada	41	67	96	76	62	38	38	33	29
New Mexico	71	39	153	130	103	63	67	52	51
Oregon	80	134	271	216	170	110	106	88	82
Utah	54	56	140	125	114	64	61	55	59
Washington	159	211	301	187	131	95	92	68	63
Wyoming	16	6	51	42	35	21	21	17	18

na = not available

1/ This is a forecast of potential demographic demand for housing and is based on Series II State population projections by the Bureau of the Census, and unpublished data from the Annual Housing Survey and the Current Population Survey.

2/ A housing unit is occupied if a person or group of persons is living in it at the time of the survey or if the occupants are only temporarily absent; for example, on vacation. A housing unit is "owner occupied" if the owner or co-owner lives in the unit, even if it is mortgaged or not fully paid for. All other occupied units are "renter occupied".

SOURCE: NATIONAL ASSOCIATION OF REALTORS®. Actual data from the Bureau of the Census, 1950, 1960, and 1970 Censuses of Housing; 1975 Annual Housing Survey; and the 1980 Current Population Survey.

ATTACHMENT 9.1

THE AMERICAN DREAM OF HOMEOWNERSHIP

Policy Statement Adopted by the
Board of Directors
February 8, 1982

The NATIONAL ASSOCIATION OF REALTORS® is dedicated to providing and protecting the opportunity for all Americans to own their own home. Homeownership extends beyond decent and satisfactory shelter and creates the incentive to save and invest. Homeownership allows each individual to own a piece of America. The home encourages more active participation in the community which is fundamental to our democratic system.

But homeowners and homebuyers have suffered disproportionately during recent times. Record high interest rates have kept many Americans from selling homes, depressed the value of all homes and have denied many thousands of would-be homebuyers from realizing the American dream.

Workers are being discouraged from selling their current home to buy a home nearer a better job. Consequently, the nation's businesses are suffering lower productivity and workers are receiving lower wages or experiencing unemployment.

Existing and new home sales during the past three years have declined by more than 50 percent. The cause can be traced to bad government policies which have driven interest rates to record high levels after adjusting for inflation.

In support of homeownership and democracy, we petition the Federal government to bring mortgage interest rates down by:

- reducing the federal deficit and federal borrowing to allow lendable funds to be used for housing;
- allowing the money supply to grow two percentage points faster than planned by the Federal Reserve Board and stabilizing growth to eliminate unnecessary and harmful fluctuation of interest rates;
- providing more adequate incentives for investment in homeownership to match more generous incentives provided for other investment;
- allowing Individual Housing Accounts for first time homebuyers (pattered after Individual Retirement Accounts);
- providing a housing mortgage tax credit for investors to stimulate an increasingly larger proportion of home mortgages; and

'ATTACHMENT 9.2

- providing a tax credit as assistance to those who wish to own a home. The tax incentive could take a variety of forms, should be temporary, and should be structured to qualify the largest possible number of first time homebuyers for mortgage loans.

Short-term programs should be designed to merge smoothly into long-term programs. Any type of housing assistance should be matched with offsetting spending reductions or tax programs. These programs should not add to the Federal deficits, but reduce the deficit in 1984 and beyond, which has been the primary cause of high real interest rates.

Every American should have the opportunity for homeownership. Every American should have the opportunity for adequate shelter and the opportunity to save and invest in their own home. Just as important, every person should have the opportunity to participate in our democratic process by owning a piece of their country.

We recognize that government policy has caused high interest rates which threaten the viability of savings and loans and community banks, which have traditionally provided mortgages for housing. We recognize further that economic policies have not adequately encouraged savings and, in fact, have encouraged consumption.

The NATIONAL ASSOCIATION OF REALTORS® supports measures to encourage increased savings and the development of programs to insure a greater flow of funds into mortgages, including more mortgage lending by thrifts and community banks. The Adjustable Rate Mortgage, with homeowner safeguards against abrupt changes in monthly payments, will lower the risk of mortgage lending for those affected by the current housing crisis. We expect the fixed payment and fixed rate mortgage (fully amortized) will continue to be relied upon, particularly as stabilized interest rate conditions return. In the transition we would support assistance for the thrifts that can be viable in the long run with limited federal help.

The NATIONAL ASSOCIATION OF REALTORS®, in pursuit of its goal of affordable housing opportunities for the nation as a whole, is seriously concerned with recent public actions and proposals.

- We think it unwise to tolerate huge and growing federal deficits and federal borrowing that takes away a large proportion of people's savings and reduces investment in housing.

- We think it unwise to slow money and credit growth so severely that it continues the recession and undermines homeownership.

- We think it unwise to cause interest rates to fluctuate so widely that it raises unnecessary fears about the future.

- We think it is unwise to permit savings and loans, which were created to serve homeownership, to invest every deposit dollar outside home mortgages.

ATTACHMENT 9.3

- We think it is unwise to encourage economic concentration and less competition by promoting vertical, horizontal and conglomerate mergers of financial entities which transfer control of savings and investment from communities to national and international financial and other organizations.

- We believe it unwise to encourage or permit savings and loan and banks to lend to their subsidiaries for businesses outside of banking, thereby undermining competition in other industries and compromising fiduciary responsibilities to depositors.

We urge all Americans and our government to keep alive the American dream of homcownership.

ATTACHMENT 10

HOMEOWNERS LOSS IN VALUE OF HOUSING

Value to Seller		Buyer's Monthly Principal and Interest Payment
$72,100	Normal Conditions Mortgage rate 10% (3% real)	$506
$66,800	Current Market with "people-to-people" financing 13% (6% real)	$591
$55,400	Current Market with new mortgage interest rates provided by financial institutions 17% (10% real)	$631

Everybody loses in the current market. Sellers are forced to sell at prices which have not kept up with inflation and sacrifice to provide "people-to-people" financing. Effective sales price is thus $16,700 below that received in normal circumstances.

The seller's loss does not turn out to be the purchaser's gain, however. A purchaser of a home for $55,400 at today's interest rates would have principal and interest payments of $631 -- $125 more than for the purchase of the home for $72,100 at 10 percent interest. The "people-to-people" financing price and interest rate minimize both the seller's loss and the buyer's payment jump.

ATTACHMENT 11

NATIONAL ASSOCIATION OF REALTORS HOUSING PROPOSALS

America's Housing Industry is in a Depression:

- The current slump in home sales is five times worse than at any time in the post-war period...
- Economic activity associated with housing construction and sales which has been lost in the last three years amounts to almost $200 billion...
- Over two million housing and related jobs have been lost since 1980...
- Only five percent of non-homeowners can qualify for an 80 percent mortgage on a median-priced home, and lenders have effectively shut the window on mortgage lending activity.

The NATIONAL ASSOCIATION OF REALTORS® recommends:

- Provide administrative and legislative changes to the Mortgage Revenue Bond program to increase the number of bonds that can be issued and make mortgages provided by the bonds more widely available. 500,000 families could achieve homeownership under this program within one year of the date these changes are adopted.
- Allow first-time homebuyers a credit against Federal income taxes of up to $5,400 on the purchase of a home between March 1 and December 31, 1982. The result would be that more than 250,000 first-time homebuyers, who would not otherwise have been able to afford a home, could purchase a home in 1982.
- Allow mortgage lenders a credit against federal income taxes of up to $5,400 if they make home mortgage loans during the period March-December, 1982. In order to qualify for the credit, lenders would be required to use the amount of the credit to decrease the effective rate of interest on the mortgage by three percentage points for a three-year period.

Where's the Money Coming From?

Much, if not all, of the cost of such a program could be recouped through a curtailment of the existing All Savers program as of March 31, 1982, instead of its current ending date of December 31, 1982.

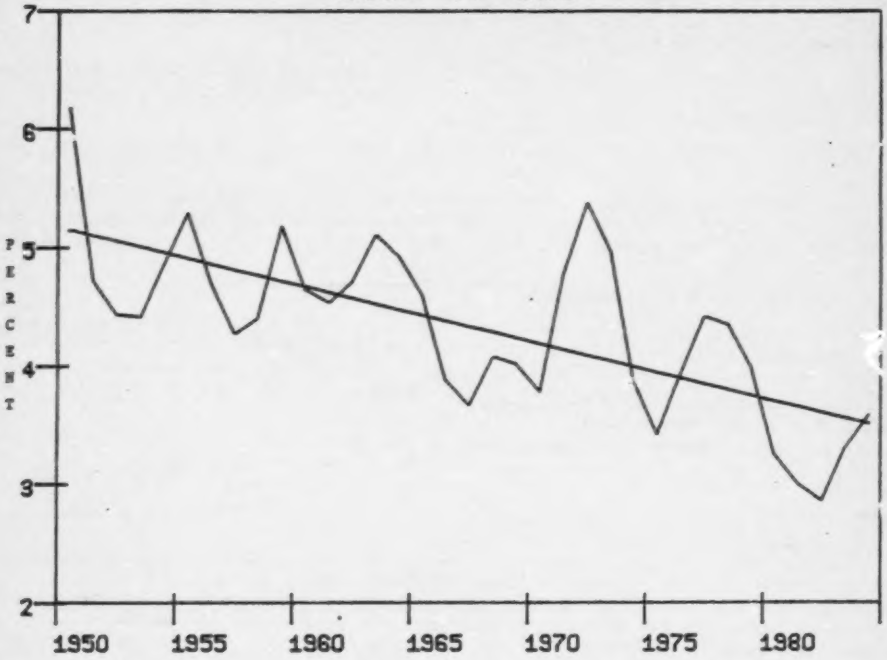
Revenue loss estimates for the All Savers program, at the time of enactment, were $3.3 billion. As of this date, some $700 million of that amount has been "consumed" by the issuance of All Savers Certificates, leaving $2.6 billion unused by the program. Current estimates are that the program will not be significantly expanded between now and March 31.

POSSIBLE DOLLAR SAVINGS TO HOMEBUYER
ON MONTHLY MORTGAGE PAYMENT FOR PRINCIPAL AND INTEREST
IF TAX CREDIT IS USED TO "BUY DOWN" INTEREST RATE

MORTGAGE INTEREST RATE WITHOUT CREDIT	MORTGAGE INTEREST RATE WITH CREDIT	MONTHLY PAYMENT FOR PRINCIPAL AND INTEREST WITHOUT CREDIT	MONTHLY PAYMENT FOR PRINCIPAL AND INTEREST WITH CREDIT	DOLLAR SAVINGS PER MONTH	DOLLAR SAVINGS PER YEAR
17%	14%	$855	$710	$145	$1740
16	13	806	663	143	1716
15	12	758	617	141	1692

ATTACHMENT 12.1

Share of Housing in National Output
1950 to 1984



ATTACHMENT 12.2

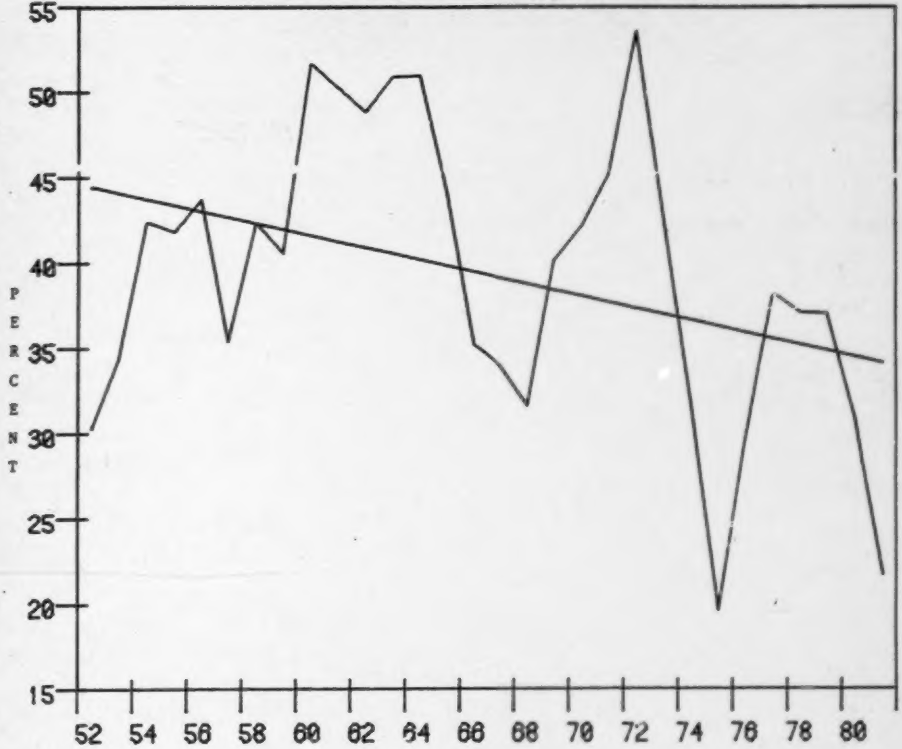
HOUSING AS A SHARE OF GNP

PERIOD	HOUSING SHARE OF NATIONAL OUTPUT
1950 - 1959 Average	4.8
1960 - 1969 Average	4.4
1970	3.8
1971	4.8
1972	5.4
1973	5.0
1974	3.9
1975	3.4
1976	3.9
1977	4.4
1978	4.3
1979	4.0
1980	3.2
1981	3.0
1982 (Forecast)	2.9
1983 (Forecast)	3.3
1984 (Forecast)	3.6

Source: National Income Accounts and estimates by the National Association of Realtors®.

ATTACHMENT 13

Share of Housing in Total Funds Borrowed
On U.S. Credit Markets, 1952 to 1981



ATTACHMENT 14

NATIONAL ASSOCIATION OF REALTORS

REALTOR®

John R. Wood, President
Julio S. Laguarta, First Vice President
Jack Carlson, Executive Vice President

925 15th Street, N.W., Washington, D.C. 20005
Telephone 202 637 6800

January 21, 1981

Dear Association Member:

For more than 14 months now, the NATIONAL ASSOCIATION OF REALTORS®, on behalf of its more than 750,000 members, has been stressing the effect of poor economic policies on the housing industry.

However, it is not just our industry that has suffered and continues to be damaged by high inflation. Virtually every area of our nation's economy is feeling the burden of the poor mix of fiscal and monetary policies.

On both January 16 and January 19 we offered recommendations to the new administration and Congress and we stressed that we are willing to sacrifice in areas that affect housing and other real estate because in the long run we are confident our industry will benefit.

I am taking this opportunity to ask you to join in this approach -- sacrifice now for future economic strength -- and have enclosed the advertisement we employed and some of our material. First, insist that our government slow overall spending, reduce the federal deficit, provide tax relief directly for encouraging savings and investment as proposed in the attached advertisement we placed in major newspapers January 19. Second, do your part by recommending programs that benefit your industry be trimmed, as we have.

If we can be helpful to you, please call me at 202/637-6891.

Together we can get our economy and our industries back on track. And now is the most appropriate time to begin.

Sincerely,

Jack Carlson
Jack Carlson

Enclosures

ATTACHMENT 15

EXCERPT FROM STATEMENT OF THE NATIONAL ASSOCIATION OF REALTORS®
TO SENATE BUDGET COMMITTEE

April 6, 1981

Because of the need for keeping spending reductions and tax relief linked and the need to stimulate savings, we recommend limiting across-the-board personal income tax relief to 5 percent annually over the next 3 years, starting no sooner than July 1981.

ATTACHMENT 16.1

FEDERAL HOUSING CREDIT PROGRAMS

In the last decade, rapid growth of Federal credit activity through direct loans, loan guarantees, and loan insurance has had a significant effect on the Nation's economy and on financial markets. We believe Congressional scrutiny, especially that of the Budget Committees, of this credit budget is essential to the total effort of reducing the growth of Federal spending. We urge caution, however, when changing the size or scope of the individual programs within the total credit budget. Each program should be understood and analyzed by its cost to the Government, the level of risk to which the program exposes the Government, the "crowding out" effect of each specific program and the policy reasons for continuing or ending the Government's support for the program.

The Administration has proposed limiting the use of Federal Housing Administration (FHA) insured mortgages to first-time homeowners or those areas which are not served by private mortgage insurers. FHA commitment level is to be capped at $35 billion after 1983. The role of FHA, which as a working partnership between Government and private enterprise has successfully delivered housing and mortgage finance to the American families for nearly fifty years, should not be altered during this period of depression in the housing industry. The non-subsidized FHA programs have operated since their inception as actuarially sound, user-fee supported programs that have helped

ATTACHMENT 16.2

to deliver affordable mortgage finance to homebuyers.

Rather than providing a subsidy to these homebuyers, FHA assists individuals to pool their risk to compete in credit markets with large corporate and international borrowers. The value of FHA insured loans to lenders comes from FHA's accessibility to the secondary mortgage market through the Government National Mortgage Association (GNMA). GNMA allows lenders to pool mortgages for investment as securities which have been able to compete for investor dollars as individual mortgages could never do. The GNMA mortgage-backed securities program is also an actuarially sound program which does not add to the Federal budget or the deficit.

The Administration proposes, however, to gradually reduce the commitment level of GNMA from the $68 billion for 1982 authorized by Congress to $48 billion in 1982 and $38 billion in 1983. The Administration suggests that limiting GNMA commitments will automatically shift its function to private mortgage-backed securities. But as the President's Commission on Housing has pointed out, while the Government should encourage a transfer of GNMA's function to the private sector, the Government must create the environment necessary for the private sector to fill the void. Simply limiting GNMA's commitment level will not work for the following reasons:

- Private mortgage-backed securities will never be a viable investment until the volatility of interest rate fluctation is reduced.

- The Internal Revenue Code should be amended to place mortgage-backed securities on an equal footing with corporate securities. The gain on the discount upon sale of a corporate security is taxed as a capital gain (a maximum tax of 20 percent) while the gain on the discount upon sale of a mortgage-backed security must be taxed as ordinary income (a maximum tax of 50 percent).
- Placing continually decreasing commitment ceilings on GNMA will create problems of rationing the limited volume of available commitments.

Therefore, GNMA commitments should remain available on demand only to be replaced by private mortgage-backed securities as they are capable of bidding the business away from GNMA. An orderly transition to the private market will become especially crucial to the future of the housing industry if thrift institutions are allowed to reduce their housing commitment.

The Housing Commission recommends a continued role for governmental support of housing as a reinsurer of all mortgage-backed securities. This "moral support" for housing exposes government to little risk. Even the use of loan guarantees has significantly less overall crowding out propensity than direct Treasury borrowing, as former Council of Economic Adviser and President Reagan Adviser, Alan Greenspan, stated before the Senate Budget Committee panel on February 10th.

There were important policy reasons for government to initiate its support of housing and those reasons remain essentially the same today--the economy of this country will never expand at the rate required for a recovery without a healthy housing industry.

ATTACHMENT 17.1

REALTORS® ECONOMIC PACKAGE

IMPACT OF SUBSTANTIALLY LOWER DEFICITS
ON THE ECONOMY 1/
(Calendar Years)

	1982	1983	1984
Long Term Interest Rates (% Points)	-0.5	-1.6	-2.3
Housing Starts (Units)	105,000	350,000	550,000
Existing Home Sales (Units)	200,000	650,000	800,000
Investment in New Plant and Equipment (% Change)	0.6	2.8	3.5
Real Gross National Product (% Change)	0.3	0.6	0.9
Consumer Inflation (% Points)	-0.2	-0.4	-0.5
Spendable Income per Household ($)	$84	$185	$302
Employment	100,000	400,000	800,000

1/ Together with less restrictive credit policy

IMPACT OF INTEREST TAX CREDIT
(Calendar Years)

	1982	1983
Housing Starts (Units)	70,000	20,000
Existing Home Sales (Units)	155,000	
Real Gross National Product (% Change)	0.2	-
Employment	100,000	-

IMPACT OF EXPANDED MORTGAGE REVENUE BOND
(Calendar Years)

	1982	1983
Housing Starts (Units)	100,000	115,000
Existing Home Sales (Units)	250,000	325,000
Real Gross National Product (% Change)	0.3	0.4
Employment	200,000	300,000

ATTACHMENT 17.2

REALTORS® ECONOMIC PACKAGE

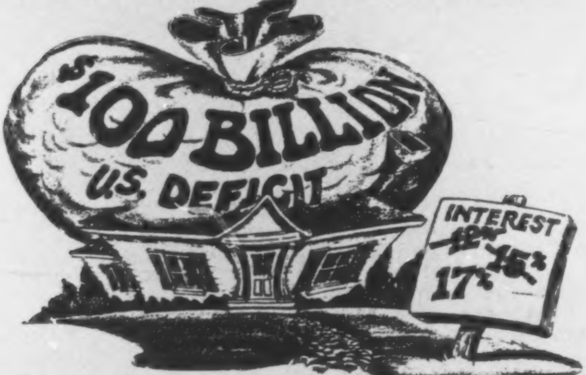
COMBINED IMPACT 2/
(Calendar Years)

	1982	1983	1984
Long Term Interest Rates (% Points)	-0.4	-1.3	-1.9
Housing Starts (Units)	200,000	450,000	550,000
Existing Home Sales (Units)	450,000	750,000	800,000
Investment in Commercial, Industrial and Agricultural Structures and Equipment (plant and equipment) % change	0.5	2.6	3.3
Real Gross National Product (% change)	0.5	0.8	1.2
Consumer Price inflation (% points)	-0.2	-0.3	-0.2
Spendable Income per Household ($)	$140	$247	$403
Employment	200,000	600,000	800,000

2/ Aggregate impact differs from the sum of the components because of the interaction effect.

ATTACHMENT 18

HOMEOWNERS: FEDERAL DEFICIT AND CREDIT POLICIES ARE CAUSING HIGH INTEREST RATES—WHICH ARE TAKING UP TO ONE-FOURTH OF THE VALUE OF YOUR HOME...



...Anyone who has tried to sell a home certainly knows it. And anyone about to sell a home will soon find out. The value of the homes of a 180 million people is being crushed. The reason: The federal government is mismanaging the economy.

Record-high interest rates are the problem. Government policies are the cause. The government is causing record-high mortgage interest rates. During the past 40 years, mortgage interest rates have averaged about 3 percent above the underlying inflation rate, which currently is about 9 percent. So, interest rates for home mortgages should average 12 percent. However, they are 17 percent or higher.

When applied to a $90,000 home, the higher interest rate drives the market value down to $65,000. Thus, a typical family can feel the loss from its savings. Homebuyers lose too. Their monthly payments are no lower—and more than 3 million homebuyers are being driven out of the market each year.

The government is depressing the value of homes by $25,000 for the average homeowner. Home values are declining for two reasons:

First, our government is causing $100 billion deficits by spending beyond its means. These record deficits are financed by borrowing so much from people's savings that very little is left for housing. The scramble for the small remaining funds results in record-high interest rates.

Second, our government is squeezing down unnecessarily hard on the growth of credit, while at the same time taking a larger share of credit to feed deficit spending.

The government is hurting home ownership in other ways.

☐ Tax relief last year created incentives to divert funds away from home mortgages.

☐ The government proposes to close down the self-supporting FHA, VA and GNMA programs that are necessary for many families to buy homes.

☐ The government is focusing on ways to help savings and loan banks at the expense of home ownership.

☐ The so-called "Housing Commission" proposes that the federal government override state laws that limit increases in interest rates on mortgages assumed when homes are sold.

☐ The administration recommends allowing savings and loans to abandon home mortgages, even though they were created to serve home ownership.

☐ The administration recommends allowing community banks to be swallowed by huge financial corporations and give them unfair advantage over small businesses who do not have protective federal charters, federal insurance and access to government credit.

☐ The administration is pursuing a philosophy that "big business is beautiful" and "small business is ugly," an approach that is likely to lead to higher costs for home ownership.

Homeowner ingenuity is keeping the American dream alive. American resourcefulness alone is keeping the goal of home ownership alive for many people. Despite the government's discouraging economic policies, buyers and sellers are striking "creative financing" agreements that make home ownership possible.

When people sell and buy homes, for example, to move to jobs, sellers are helping buyers with the financing. Also, assumptions of existing mortgages are helping. People-to-people financing is making possible about two-thirds of all home sales by providing financing at 13 percent. The people who have access to this financing find that now is a good time to buy and sell. However, most other Americans have to face the 17 percent government-caused rates.

But homeowners can't go it alone forever. If the government were demonstrating the same resourcefulness as the American people, we would realize the American dream for millions more.

What can homeowners do? Homeowners must act now to make democracy work. They must change the policies that are draining away their life savings. We must insist that the President, the Congress and the Federal Reserve Board act responsibly.

(1) The federal deficit must be reduced from the record $100 billion in 1982 toward $50 billion in 1983 and balance in 1984—by cutting the growth in spending to live within the government's means and, if necessary, by delaying tax relief in ways that will encourage savings and investment.

(2) The President, the Congress and the Federal Reserve Board must work to bring interest rates down—by allowing credit and money to grow 1 to 2 percentage points faster in 1982 than is planned by the Federal Reserve Board, and by reducing the fluctuation in interest rates.

The federal government must serve the credit needs of housing and industry and not just its own needs for credit.

Here's how to get your message to your congressmen. Fill out the coupon below and mail your message to us. We will see that your message gets to each of your U.S. senators and your representative. In addition, we will keep you informed of the progress on a monthly basis.

Clip the coupon below and mail it to:

NATIONAL ASSOCIATION OF REALTORS®
F Street Station, P.O. Box 50315, Washington, D.C. 20004

Dear Senators and Representative:

I am angry about the loss of one-fourth of the value of my home, which is being caused by the government's failure to live within its means. I have saved and invested in my home and I don't want the value taken away because of bad government policies.

I urge you to work for policies that will slow the growth of spending and change tax policy to reduce the deficit toward a balanced budget in 1984. Also, the Federal Reserve Board should be encouraged to increase the growth of credit 1 to 2 percentage points to help bring interest rates down.

Name

Street Address

City State Zip Code

NATIONAL ASSOCIATION OF REALTORS®

ATTACHMENT 19

JOINT STATEMENT OF

AMERICAN BANKERS ASSOCIATION
MORTGAGE BANKERS ASSOCIATION OF AMERICA
NATIONAL ASSOCIATION OF HOME BUILDERS
NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS
NATIONAL ASSOCIATION OF REALTORS
U.S. LEAGUE OF SAVINGS ASSOCIATIONS

FEBRUARY 25, 1982

Prolonged high interest rates are creating an economic and financial crisis in this country. In order to bring interest rates down, immediate action must be taken to reduce massive federal budget deficits. More than anything else, it is the spectre of an overwhelming volume of deficit financing which haunts housing and financial markets and poses the threat of economic and financial conditions not seen since the 1930s.

Given these circumstances, there is no alternative to: (1) slowing down all spending, not excluding defense and entitlement progams; and, if necessary, (2) deferring previously enacted tax reductions or increasing taxes. In order to have the necessary impact on financial markets, these actions should be taken prior to any increase in the ceiling on the federal debt.

Even with these actions, the restoration of financial stability and safety will be a prolonged process. It is necessary, therefore, to adopt immediate but temporary measures to address the critical problems of the industries which finance, market and produce housing for American families. These industries have unfairly borne the brunt of destructively high interest rates. Unless immediate and effective short-run measures are adopted, the continued devastation of these industries will, directly and indirectly, aggravate the federal budget deficit and greatly increase the prospect of a general economic and financial crisis.

In times of past crises in this nation, our political leaders have come together in a bipartisan manner to develop effective solutions in the common interest. Our nation is at such a time now. There will be no political winners if the Administration and the Congress fail to accommodate differences and cooperate in dealing with current serious economic problems. The threat to our nation demands prompt, effective and bipartisan action.

Llewellyn Jenkins
Llewellyn Jenkins, President
American Bankers Association

James F. Aylward
James F. Aylward, President
Mortgage Bankers Association

Fred Napolitano, President
National Association of Home Builders

Robert B. Masterton
Robert B. Masterton, Chairman
Mutual Savings Banks

Julio S. Laguarta, President
National Association of Realtors

Roy G. Green
Roy G. Green, President
U.S. League of Savings Associations

ATTACHMENT 20

OVERRUN IN FEDERAL SPENDING CONTRASTED TO PRESIDENT'S ORIGINAL COMMITMENTS
(Dollars in Billions)

Fiscal Year	Initial (January) Budget Estimate	Actual Budget Spending		Spending Overrun	
				Percentage	Amount
1972	$229.2		$232.0	1.2	$2.8
1973	246.3		247.1	0.3	0.8
1974	268.7		269.6	0.3	0.9
1975	304.4		326.2	7.1	21.8
1976	349.4		366.4	4.9	17.0
1977	394.2		402.7	2.2	8.5
1978	440.0		450.8	2.4	10.8
1979	500.2		493.6	-1.3	-6.6
1980	531.6		579.6	9.0	48.0
1981	615.8		660.5	7.3	44.7
1982	695.3 (3/10/81)	May 15 -Congress	695.5e	0.0e	0.2e
		July 15 -President	704.8e	1.4e	9.5e
		Sept. 10 -CBO	723.0e	4.0e	27.7e
		Sept. 24 -President	709.3e	2.0e	14.0e
		Feb. 8 -President	729.2ef	4.9e	33.9e
		-REALTORS®	742.7ef	6.8e	47.4e
72-82 Average				3.7e	17.8e
1983	762.1f	Feb. 25 -CBO	785.1ef	1.7	13.0

e = estimate
f = adjusted for comparability by increasing $4.4 billion in 1983 and $3.9 billion in 1982 for SMI and VSI Insurance premiums excluded from spending figures starting in 1983 budget.

SOURCE: Budgets of the U.S. Government, First Concurrent Budget Resolution 1982, Congressional Budget Office Reports, and public statement of the President.

The CHAIRMAN. Senator Byrd.

Senator BYRD. I have no questions.

The CHAIRMAN. Senator Boren.

Senator BOREN. I am well aware of the desperate situation that you describe in this whole industry, and I am very sympathetic to it. I hope that we can take some action that will result in improving the situation.

Of course, anything we can do to bring the interest rates down quickly is of major importance. I don't think we have a year to look at it, frankly. I think we are going to see very serious harm to the economy that will be impossible to patch up if we allow this situation to continue for as long as another 12 months.

I also agree with your comment that we have to take every action possible to lower the deficit and to also narrow those deficits in the outyears as the investors in the bond market look ahead at them.

I happen to think that the market has been responding rather rationally. I don't think we can blame them for the fact that interest rates have stayed high, because when they look at it and see outyear deficits looming in the hundreds of billions and perhaps to the trillion dollar range over the next 5 or 6 years, they are being prudent in giving themselves a little cushion in terms of these long-range interest rates.

I think it is up to us, whatever it may take, even if it takes triggering or deferring the third year of the tax cut, even if it takes looking at entitlements, cost-of-living formulas, whatever is necessary in order to narrow that deficit. I think there are a growing number of us who are prepared to do it.

The evidence that you give us and the reports of the dropping membership of your association I think add to the urgency of our need to act. And I appreciate your testimony this morning very much.

Mr. THURM. Thank you, Senator.

The CHAIRMAN. In some of the matters you covered in your statement, there would be revenue loss associated with that; is that correct?

Mr. THURM. Yes, Mr. Chairman, as far as a tax credit for home buyers; although we would suggest that no new revenue expenditures be created. We would strongly recommend that there is a program now on the books known as the all-savers certificate which has not produced the results Congress intended as far as relief for housing.

We understand that there was a revenue estimate that that program would cost in the nature of $3.3 billion. Well, today, Mr. Chairman, you can't find any savings and loans or banks or other institutions advertising or promoting the all-savers certificate. You don't see any signs in windows. We suggest that if that program is not doing what it was intended to do it be cut off right now.

We understand that less than $700 million of funds were utilized thus far. That would leave in the nature of $2.6 or $2.8 billion left for this tax credit that we are suggesting today. We do not suggest deficits over and above that amount.

The CHAIRMAN. Well, in the whole industry, I had the staff take a look at some of the tax benefits in fiscal year 1982 to the housing industry. Mortgage interest deductions, $23.1 billion; property tax deductions, $10.1 billion; housing bonds, $1.5 billion; rollover of capital gains, $1.5 billion; over-55 capital gains exclusion, $500 million; special rental housing depreciation, $500 million; special expensing for construction period interest and taxes, $700 million; all of which adds up to $37.9 billion in tax benefits in fiscal year 1982.

Now, you are not suggesting we change any of those to take care of any other suggestions, are you?

Mr. THURM. No, Mr. Chairman, because even with those important incentives the housing industry is still in its horrible condition we face today.

The CHAIRMAN. But it seems, despite all those tax benefits, the housing industry is still not insulated from the ups and downs in the economy. It may be that that nearly $40 billion in benefits just gets passed through in inflated housing prices and does nothing for the real health of the industry.

I am not suggesting that we start dismantling some of those programs, but I think there are areas that should be focused on in the list I just mentioned.

Yesterday we had some local government officials who pleaded with us to limit the private-purpose bonds in order to save the traditional municipal bond markets—bonds for sewers, schools, roads, and so forth. And you argue for more private-purpose bonds in more private housing bonds.

Now, should I vote for more expensive schools and sewers and roads for many citizens to get a little cheaper housing for a few?

Mr. THURM. I think that's a very tough situation that this committee is going to face, Mr. Chairman. I think that there are purposes for both. Needs must be met on both sides.

I think what we have to look at is some modest improvements. We are not looking for expensive programs; we are not looking for great new deficits. I think that there are mechanisms already available, even in conference today, on the mortgage bond area involving housing that can be incorporated and enacted on without any increased spending.

The CHAIRMAN. Senator Boren.

Senator BOREN. I wanted to go back to your statement in regard to the all-savers not working.

In your opinion, I wonder about what the principal reason would be. Is it because it was too short term? In other words, you have a reasonable cost of money for 1 year, and obviously you are not going to take the risk for a 20- or 30-year loan not knowing whether it is going to be there? Was it not sufficiently targeted to housing?

Mr. THURM. Yes, Senator.

Senator BOREN. Was it the fact that we got the national brokerage firms and others involved in selling them rather than staying in local financial institutions where it might be loaned to housing? All these factors? Which would you single out as the most important reason?

Mr. THURM. Senator, I think there was a combination of factors, but I think the primary problem that we saw was the less than sufficient targeting for housing.

Originally the proposal was designed to provide the funds to go directly into housing, but during the legislative process that area got broadened considerably. We have a situation today where institutions can raise all the funds they desire and not invest even a penny in housing, the only penalty thereby being that they cannot go and create other funds.

The CHAIRMAN. Congressman Jenkins and I had a proposal last year which would have targeted the proceeds essentially to housing and another rather narrow range of purposes.

Do you think there could have been a substantially different result had we gone in that direction?

Mr. THURM. Yes. We strongly supported the Boren, Jenkins, and Archer proposals last year. We applauded your efforts to have a more significant housing tie.

Senator BYRD. Could I ask a question?

The CHAIRMAN. Yes.

Senator BYRD. Would you give an example as to how your tax credit for the lender would work?

Mr. THURM. Yes, Senator. We think that a tax credit approach can be designed to provide the tax credits to go either to the home buyer or the lender. In the case of the lender, a lender who makes a housing loan to enable a first-time home buyer to purchase an existing or new home would receive a tax credit of up to $5,400 under our figures although we are flexible and will work with the committee as far as working out what the best approach is. But the tax credit going to the lender would be earmarked as a buydown of sorts on the cost of the interest rate. In other words, that tax credit going to the lender would then be used by that lender to lower the interest-rate cost to the home purchaser for a period of at least 3 years.

Senator BYRD. Well, the $5,400 that you mentioned, is that over a period of years, or is it annual?

Mr. THURM. The $5,400 would be a one-shot credit now, and that would be used to buy down that interest rate.

The CHAIRMAN. Thank you very much.

Mr. THURM. Thank you, Mr. Chairman.

The CHAIRMAN. Our next scheduled witness is the Honorable William Winter, Governor of the State of Mississippi. I understand he has not yet arrived; is that correct?

[No response.]

The CHAIRMAN. He is not here. So we will move on to our final panel of the morning, consisting of Mr. Frank Borman, president, Eastern Airlines; Mr. F. G. Jaicks, chairman of Inland Steel Corp.; Mr. William L. Seidman, vice chairman, Phelps Dodge Corp.; and Mr. Charles Dickey, chairman of Scott Paper Co..

Let's see now, are you going in the order that your names were read?

Mr. SEIDMAN. If it is all right with the chairman, I will lead off.

The CHAIRMAN. Fine.

Let me just make one statement, because I think it may have some bearing on the testimony: I have had the staff of the Joint Committee on Taxation make a preliminary survey of this provision because, as you know if you read the papers and have heard some of the statements this morning and if you were here at the hearing last December, the provision is in some jeopardy.

So we have had the staff of the Joint Committee on Taxation preliminarily review some of the safe harbor leasing information returns for 1981. I understand they have concluded that 2 percent of the benefits from the safe harbor leasing was received by lawyers, investment bankers, and other third parties. They estimate that such fees exceed $100 million last year. I don't believe that Congress ever intended such large-scale subsidies for lawyers and investment bankers when it passed this provision.

The joint committee's preliminary review suggests that 22 percent of the benefits from leasing is received by the purchasers of the tax benefits and that the remaining 76 percent goes to the lessee. The profitable companies have already received tax benefits valued at $1 billion as a result of the leasing transactions. I would indicate that these numbers are preliminary, and I say this to challenge the panel, because you have got a difficult job if you intend to save any portion of this program.

Thank you.

STATEMENT OF WILLIAM L. SEIDMAN, VICE CHAIRMAN, PHELPS DODGE CORP.

Mr. SEIDMAN. Thank you, Mr. Chairman. I appreciate the opportunity to talk to you and to the distinguished members of your committee.

To begin with, I would like to point out that we have a survey by Arthur Andersen & Co. dealing with some of the same kinds of numbers which you have just referred to and which are somewhat different. I will point that out as I go along.

Mr. William Penick, of Arthur Andersen, is here, and he can perhaps discuss with you some of the differences in the results of these preliminary looks at this problem.

We know that safe harbor leasing is under sharp focus, and we welcome the chance to deal with some of the key issues which we believe are involved. I would like to deal with four of them, if I may.

The first is that safe harbor leasing is being said to be a subsidy, that Congress did not intend subsidies to corporations in the Tax Act. We would like to dispute that statement.

Safe-harbor leasing is really the means by which all corporations, profitable or nonprofitable of whatever type investment they make, can compete on an equal basis. The example in our own industry: Our principal competitor is owned by an oil company. They automatically, therefore, get all the tax savings in the bill, and therefore, get the benefit which we have to obtain by safe harbor leasing.

The basic reason that the administration recommended the safe-harbor leasing was to make sure that it worked evenly across the board in American industry, and in our view that has been the effect.

The second point I would like to address is that safe-harbor leasing beneficiaries as far as the sellers are concerned, the distressed industries, are inefficient types of industries, losers, the types that should not receive any benefits.

The Arthur Andersen report shows that the principal beneficiaries are distressed industries in the basic industries in our country. The people that are receiving the benefits—and I will address the percentages in a minute—are capital-intensive industries: steel, automobiles, airlines, railroads, mining, paper, cement, and many others.

Now, the question can be raised: How can it be that all of these industries are distressed? I think the common factor involved is that those are the industries that have been most hurt by the inflation which we have had over the last 10 years. And inflation erodes capital, no matter what the skills of the management are present.

So these industries are in the position they are in primarily because of economic policies to which they have been subject in the past. They are all viable industries, all industries which must recover if we are going to have a sound economy in this country.

Now let me address the third point, which is the one I believe has had the most publicity, and that is that very large amounts of benefits are going to profitable giants who are really ripping off the benefits which were intended for the distressed industries.

First, the Arthur Andersen report which goes into that in some detail provides an answer which is considerably different than the joint committee's. It says that 95 percent of the benefits are going to the distressed industries. As one of the distressed industries, we made our own studies in that regard, and we come up with comparable-type statements.

[This report is in the official committee files.]

Mr. **Seidman**. The fact of the matter is that there is an open market out there, and that marketplace is taking care of seeing that fair prices are paid for the tax benefits. And I think it ought to be clear that the companies that are announcing that they had great reductions in tax do not have that kind of a windfall. They paid for that tax reduction by passing along the benefits to distressed industries. In effect, they simply bypassed the Treasury. They could have paid it to the Treasury, and the Treasury could have paid it to the distressed industries.

My final point is with regard to overall economic policy at this time. As you all know, we are in a very deep recession. And the companies here involved are right at the bottom of that recession. They are all in a position where if they receive these benefits they will spend them on capital. If they don't receive the benefits, then most of them will not spend their capital. At a time when we need capital spending to spur recovery, to create jobs, and to improve productivity, it would seem a very inopportune time to change this particular provision of the law.

In summary, we think that the law is working exactly the way the administration designed it, and we ask that you carefully consider before you make changes.

Thank you very much.

The **Chairman**. Mr. Dickey.

STATEMENT OF CHARLES DICKEY, CHAIRMAN, SCOTT PAPER CO., WASHINGTON, D.C.

Mr. DICKEY. Yes.

Mr. Chairman, I will briefly summarize my written statement in my oral remarks and request that the written statement be incorporated in the record.

Scott Paper Co. is testifying today in support of the safe harbor leasing provisions in the Economic Recovery Tax Act of 1981. It is worth noting that the safe harbor leasing is the only provision in last year's tax bill that has any meaningful impact on Scott Paper Co. Furthermore, no legislation is of greater importance to many of America's capital-intensive industries.

Within the past year Scott has embarked on the most aggressive capital spending plan in the company's history. We plan to spend $1.6 billion over 5 years to expand capacity, to modernize our plants, to increase productivity and to reduce our dependence on foreign oil. Capital spending for 1982 will be almost half a billion dollars, and that's up more than 40 percent over last year and 80 percent over 1980. This capital program, which provides thousands of construction jobs alone, is the largest and most important project we have ever undertaken.

Both the magnitude and timing of our capital spending plans are related directly to safe harbor leasing. Either the repeal or a drastic modification in safe harbor leasing transactions would force indefinite postponement or cancellation of large parts of our capital plan, and these would total several hundred million dollars.

Scott Paper Co., along with many other major firms in our industry, has been an active seller or lessee in the leasing market. In 1981 we entered into several transactions involving millions of dollars of capital equipment in 14 States, and we received about $50 million in badly needed cash. The cash we received was immediately put to work to finance more projects. We have expected to participate in further transactions in 1982 and in 1983 in the same magnitude. Importantly, the funds we plan to receive are an essential ingredient in financing our capital projects both this year and next.

There are two basic facts which must be understood:

First, safe harbor leasing is nothing more than a financing mechanism. It provides companies like ours with tax benefits we have earned as a result of our capital spending plans in progress, but which we would otherwise not receive.

Second, safe harbor leasing is an absolutely necessary part of the accelerated cost recovery system. Without safe harbor leasing, Scott Paper and many other capital intensive firms would have received no direct benefit and would be at an even greater competitive disadvantage as a result of the accelerated depreciation bill passed last year.

To underscore this point, we computed the benefit of the 10-5-3 proposal. We determined that over a 5-year period the accelerated depreciation proposal would have generated $250 million in additional deductions for Scott, while yielding less than $10 million in actual tax savings. The reason is simple: tax benefits generated from our capital program were exceeding our earnings capacity. From a competitive point of view, the accelerated depreciation proposal would have actually hurt us more than it helped. The leasing idea was born out of attempts to correct this problem, and it has worked very well. And Scott is a perfect example of how well it is working.

One problem which has been especially vexing, Mr. Chairman, has been the artificial suspension of the leasing market since February 19. Because leasing transactions are now extremely difficult to put together, there has been a sharp reduction in projected cashflow which threatens current capital projects.

We are anxious to work with the committee to eliminate perceived abuses of the law, but we urge the committee not to destroy this essential procapital formation and procapital spending law in the process. Some in Congress have called for a review of leasing. We welcome a review, because we know of no other Federal tax policy for business working so well and so quickly.

In summary, it has been our experience that leasing has been working exactly the way it was intended to work. It has encouraged us to continue our large capital expenditure programs. It has provided equal access to tax benefits earned by capital projects. Its repeal would have an immediate and very negative impact on our company. We urge the committee to give its full support to policies that provide these incentives to capital intensive industries. The current economic recession serves to underscore the need for this equitable tax law.

The CHAIRMAN. Thank you, Mr. Dickey.

Mr. DICKEY. The next person on our panel will be Mr. Frederick G. Jaicks, chairman of Inland Steel Co.

STATEMENT OF FREDERICK G. JAICKS, CHAIRMAN, INLAND STEEL CORP.

Mr. JAICKS. Mr. Chairman, members of the committee.

I am Fred Jaicks, chairman of Inland Steel. If you will permit me, just a very quick profile of our company.

We are a Chicago-based integrated steel producer employing about 35,000 men and women and the seventh largest company in the domestic industry. For many years we have had one of the best profitability records in the industry. We have reported profits every year since 1932.

We, along with the majority of the domestic producers, have been encountering a severe profits squeeze for the past couple of years, a combined result of the state of the economy, the depressed condition of several of our major markets including the automobile market, and the impact of imported steel.

In our case, we actually reported a loss in the fourth quarter, and we may be faced with that situation again in the first quarter of this year. I guess that places us in a distressed industry in a distressed period.

My purpose is to explain from our perspective the practical importance of safe harbor leasing provisions for the steel industry and Inland.

To return to acceptable levels of profitability and reliable employment, to improve our competitive position vis-a-vis foreign competition, it is imperative that the industry move forward in a program of modernization. This is most difficult during a period of profits squeeze, with its inherent limitations on internally generated funds and restrictions on the amounts that we can prudently borrow.

The dollars to accomplish this are big. In Inland's case, we finished in 1980 a $1 billion program started in the mid-1970's and had a second phase planned to start immediately thereafter. However, with the recession in the steel business, which is still with us, we were forced to conclude this expansion. The second phase should be substantially cut back, at least for the present.

Thus, in 1981 our capital expenditure program was restrained and held to approximately $135 million, against $240 million in 1980. The restraints are still being exercised.

The steel industry generally has similar massive requirements for modernization expenditures. Since November 1980, individual steel companies have announced modernization programs totaling more than $6.5 billion. The struggle that will be required to justify and finance expenditures of this magnitude under today's conditions is obvious.

Inland and the steel industry vigorously supported the Economic Tax Recovery Act of 1981, particularly the ACRS incentive system, in the belief that it would aid saving and investment. But without the safe harbor leasing provisions, steel companies and other capital intensive industries will be unable to use much of the investment incentives which Congress provided, because taxable profits from existing assets are insufficient to absorb the incentives generated by new assets.

Inland's profits have simply not been large enough to absorb the investment credits generated by its prior large investment program. The combination of new operating profits for 1980 and 1981 and the incentive depreciation deduction allowed for tax purposes produced net operating losses for tax purposes.

Even with an upswing in business, safe harbor leasing will be important to our industry. Congress has designed the tax incentives in such a way that their usability depends upon the ratio of new investments to taxable income. Companies with large amounts of new investments, which generally include capital intensive industries like steel, are likely to have continuing needs.

Given the capital intensive nature of the steel business and the massive modernization expenditures that need to be made, we project that even with more normal profit levels and a more robust economy it will be a number of years before all the tax incentives we generate can be absorbed currently.

The discontinuance of the ACRS investment credit incentives through safe harbor leasing or some comparable mechanism will have two similar but distinctly adverse effects.

First, the inability to use the incentive restricts the funds that can be made available to finance new investment. We simply can't build facilities for which we do not have money. We can see in the marketplace that in the aggregate the incentive tax benefits provided by law may supply cash equal to 30 percent or more of the cost of the asset. If the incentives are available we can obviously do much more than if they aren't.

Second, the inability to use the incentive increases our effective capital costs in comparison with others, which makes us and our profits less competitive, further squeezing our profits. For example, in 1981, when it became clear that Inland would not be able to absorb its unused tax credits currently, our financial staff calculated that Inland's net capital cost for new facilities would be 30 to 40 percent higher than the net capital cost of similar facilities to a company who could use the incentives currently. With higher costs, our profits will obviously be less; and that prospect is an obvious deterrent to a new investment. By entering into a safe harbor lease, we calculated we could eliminate 70 to 80 percent of this excess capital cost, leaving us with not all but most of the incentives provided.

In summary, restrictions of safe harbor leasing would, in my view, force steel companies that can't directly use tax incentives available to other companies to scale back important portions of their vital modernization program at a high cost in terms of the Nation's industrial strength and employment and competitiveness.

Thank you, gentlemen.

Mr. SEIDMAN. I would like to call now on our last panel member, Mr. Frank Borman, chief executive officer of Eastern Air Lines.

STATEMENT OF FRANK BORMAN, PRESIDENT, EASTERN AIR LINES, WASHINGTON, D.C.

Mr. BORMAN. Mr. Chairman, may I use slides?

The CHAIRMAN. Fine.

Mr. BORMAN. I have five slides. You have my testimony, but I have kind of a case study of how this affected Eastern, and I would like to use that, if I may. [Showing of slides.]

I want to discuss with you the purchase of $900 million of capital equipment, a Boeing 757. We entered into a purchase agreement with Boeing in 1978, Eastern's most profitable year, in the middle of a 4-year string of the most profitable years of Eastern's history.

We ordered these airplanes not for expansion but to replace aging 727-100's which will be 16 years old and are completely fuel inefficient.

Now in the intervening time period, the next slide shows you what happened to our industry. [Change of slides.]

This is the performance, 1981, for the industry in general. At the operating level there were only four profitable trunks. As you can see, that ranges from 17 for Northwest to 86 for Delta. Eastern was about in the middle of the path, with a $50 million operating loss.

This loss, coupled with the unsatisfactory performance in 1980, led us to reevaluate these airplanes that we had on order—the 27 757's. And in July of 1981, I was at Boeing trying to negotiate either the cancellation of a third of those airplanes or the stretch-out; and I'll show you the impact of that on the next slide.

[Change of slides.]

We have 21 of the first 40 airplanes that Boeing committed to were Eastern orders. Of the total we have now for 1984 delivery, we have about half of them. And the performance of the industry in 1980 and 1981 jeopardized not only Eastern's participation in that program but the entire Boeing program.

I would like to submit to you that the performance of the industry, the industry's degradation, was the result of three fundamental facts: First, the enormous increases in fuel prices over which we had no control; two, the recession, which we don't think we caused; and three, the effects of deregulation, which the Congress gave us as a present in 1978.

Now, I want you to understand that I am fully in agreement with the deregulations, but it also created a severe realinement in our industry. [Change of slides.]

I told you I was out in Boeing in July attempting to cancel orders. In August you passed the safe harbor leasing. We went back and did our numbers and found that with the provisions of safe harbor leasing we could indeed continue the $909 million capital order. And we went to Boeing and said, "With the new tax law, it's go," and Boeing is in fact producing our airplanes. And they are coming down the assembly line, ready or not.

Unfortunately, the concern over safe harbor leasing does not only jeopardize the 273; but since your concern was expressed on the 19th of February, Moody's has downgraded our paper so that $300 million is now jeopardized for us. So we are in a very, very untenable position from the standpoint of being able to finance the go-through with what was a firm financial package in August. And now it has deteriorated through no actions of our own.

The other thing that the committee needs to understand: If you do away with safe harbor leasing, the few airlines that are profitable will have a $273 million advantage over Eastern. Where it costs us $30 million to buy a 757 because we can't take advantage of this, they will only have to pay $20 million. And all you are going to do is spread the discrepancy between the carriers who are profitable and who can't take advantage of the safe harbor leasing. [Change of slides.]

The last slide points out the difference between leveraged leasing and safe harbor leasing.

At the beginning of this hearing you talked about 2 percent going to investment bankers and lawyers. I submit to you that under leveraged leasing the benefits that were transferable, only about 50 to 60 percent flowed through to the seller. About 40 to 50 percent stayed with the buyers. Under safe harbor leasing, we think that we will get 90 percent at least of the benefits of the accelerated depreciation and the ITC.

I have here, under leveraged leasing we can only use it for 50 percent of our fleet; 100 percent under safe harbor. We don't get any equity benefit, and we do under safe harbor. In leveraged leasing we give up ownership. In 1973 the 16-year leveraged leases that we had on 27 DC-9's, 20 DC-9's will come to an end. Then, after having paid for these things over 16 years we will be forced to buy them again at fair market value which, because of inflation, is more than the original purchase price. So it is no wonder that the leasing companies are totally against safe harbor leasing.

That explains my position from the standpoint of one case study and how it really impacted a company that is struggling in a depressed industry.

I might say that this was not for the stockholders' benefit—we haven't been able to pay dividends for some time—the employees of

Eastern have accepted over $40 million in wage cuts to keep this thing going, and we really need safe harbor leasing to continue.

Thank you.

Mr. Seidman. That completes our presentation, Mr. Chairman.

[The prepared statements of the previous panel follow:]

SEIDMAN ORAL TESTIMONY

SAFE HARBOR LEASING

MR. CHAIRMAN AND MEMBERS OF THIS DISTINGUISHED COMMITTEE:

MY NAME IS L. WILLIAM SEIDMAN. I AM VICE CHAIRMAN OF PHELPS DODGE CORPORATION, THE NATION'S SECOND LARGEST COPPER PRODUCER. I SHALL SET THE STAGE FOR OUR PANEL DISCUSSION BY DEALING WITH SOME OF THE MISCONCEPTIONS THAT HAVE ARISEN WITH RESPECT TO "SAFE HARBOR LEASING". IN DOING THIS, I SHALL REFER TO A RECENTLY COMPLETED STUDY OF SAFE HARBOR LEASING ACTIVITY IN 1981 BY ARTHUR ANDERSEN & CO., A COPY OF WHICH YOU HAVE BEFORE YOU AND WHICH I WOULD ALSO LIKE TO SUBMIT FOR THE RECORD ALONG WITH MY WRITTEN STATEMENT. MR. WILLIAM PENICK, SENIOR PARTNER, LEGISLATIVE TAX POLICY, ARTHUR ANDERSEN & CO., IS WITH US TODAY TO RESPOND TO QUESTIONS ABOUT THE STUDY.

IT IS PROBABLY FAIR TO SAY THAT SAFE HARBOR LEASING IS AS MISUNDERSTOOD AND UNJUSTLY MALIGNED A TAX POSITION AS ANY EVER APPROVED BY CONGRESS. UNTIL THE FOLLOWING MISCONCEPTIONS THAT SURROUND IT ARE CORRECTED, SENSIBLE REMEDIAL LEGISLATION, IF NEEDED, WILL BE DIFFICULT.

#1: SAFE HARBOR LEASING IS A SUBSIDY, AND CONGRESS DID NOT INTEND ANY SUBSIDIES FOR CORPORATIONS.

FACT: THE VERY PURPOSE OF PROVIDING THE TAX BENEFITS OF FASTER DEPRECIATION AND A MORE LIBERAL ITC WAS TO ENCOURAGE NEW INVESTMENT THROUGH A TAX INCENTIVE OR "SUBSIDY". SAFE HARBOR LEASING IS SIMPLY THE MEANS BY WHICH THIS INCENTIVE/SUBSIDY IS MADE AVAILABLE TO ALL BUSINESSES, REGARDLESS OF THEIR TAX POSITION. IT IS IMPORTANT TO REMEMBER THAT SAFE HARBOR

LEASING PROVIDES NO SUBSIDY WHATSOEVER TO "LOSS COMPANIES" WHICH ARE NOT INVESTING IN NEW EQUIPMENT. IT PROVIDES NO GREATER SUBSIDY TO "LOSS COMPANIES" THAN THAT PROVIDED BY ACRS AND ITC TO CONCERNS WITH CURRENT TAXABLE PROFITS. THE LEASE KEEPS THE COST OF CAPITAL ON AN EQUAL BASIS FOR ALL CORPORATIONS, PROFITABLE AND UNPROFITABLE.

#2: MAJOR BENEFICIARIES OF SAFE HARBOR LEASING ARE INEFFICIENT "LOSERS" WHO DO NOT NEED OR DESERVE THIS TYPE OF HELP.

FACT: AS THE ARTHUR ANDERSEN STUDY NOTES:

MOST SELLERS (OF TAX CREDITS AND DEDUCTIONS) ARE WELL ESTABLISHED COMPANIES IN THE SO-CALLED "DISTRESSED INDUSTRIES" . . THEY HAVE BEEN PROFITABLE IN THE PAST BUT, DUE TO RECENT REDUCED EARNING LEVELS, HAVE ITC CARRYOVERS AND CURRENT U. S. OPERATING LOSSES WHICH MAKE THEM UNABLE TO USE ADDITIONAL TAX BENEFITS RELATED TO INVESTMENT IN NEW EQUIPMENT.

THUS, THE PRIMARY BENEFICIARIES OF SAFE HARBOR LEASING ARE CAPITAL INTENSIVE BASIC INDUSTRIES SUCH AS STEEL, AUTOMOBILE, AIRLINE, RAILROADS, MINING, PAPER AND CEMENT. THIS IS A LIST IMPRESSIVE ENOUGH TO RAISE THE QUESTION AS TO WHY THEY ARE ALL NONPROFITABLE AND SHORT OF CAPITAL. THE ANSWER IS THAT ALL OF THESE INDUSTRIES ARE THE PRINCIPAL VICTIMS OF GOVERNMENT POLICIES THAT PRODUCED OUR RECORD-HIGH INFLATIONARY ECONOMY. INFLATION ERODES CAPITAL NO MATTER WHAT MANAGEMENT SKILLS ARE PRESENT. INFLATIONARY POLICIES HAVE PRODUCED THE CURRENT RECESSION WHICH ALSO HITS HARDEST AT THE BASIC INDUSTRIAL SECTOR.

THESE INDUSTRIES DESERVE AID AS THEY HAVE BORNE A GREAT BURDEN DUE TO PAST INEPT ECONOMIC POLICIES.

#3: SAFE HARBOR LEASING IS A GIANT "RIP-OFF" IN WHICH SOME 70 TO 80 PERCENT OF THE BENEFITS ARE SNAPPED UP BY THE PROFITABLE BUYER/LESSOR.

FACT: THOSE WHO MAKE THIS CHARGE CONFUSE THE VALUE OF THE PROPERTY INVOLVED WITH THE PRESENT VALUE OF THE TAX BENEFITS TRANSFERRED BY THE BUYER TO THE SELLER; THESE HAVE GENERALLY RANGED FROM 20-30¢ PER DOLLAR OF ASSET. THE ARTHUR ANDERSEN STUDY SHOWS THAT FROM THE STANDPOINT OF THE SELLER, THE TAX BENEFITS HAVE BEEN SELLING AT OR EVEN ABOVE THE PRESENT VALUE OF THE TAX BENEFITS TRANSFERRED. ARTHUR ANDERSEN CONCLUDES THAT "SELLERS ARE RECEIVING BETTER THAN 95 PERCENT OF THE MAXIMUM TAX BENEFITS ASSOCIATED WITH EQUIPMENT OWNERSHIP THROUGH SAFE HARBOR LEASING." THIS CONTRASTS WITH THE TRANSFER OF 50 TO 60 PERCENT UNDER THE SO-CALLED "LEVERAGED LEASING" THAT HAS EXISTED IN THE TAX LAW FOR MANY YEARS. UNDER SAFE HARBOR LEASING, BUYERS ARE, ACCORDING TO ARTHUR ANDERSEN, OBTAINING YIELDS OF ABOUT ONE PERCENTAGE POINT ABOVE A BREAK-EVEN YIELD.

#4: SAFE HARBOR LEASING WAS SLIPPED INTO THE ECONOMIC RECOVERY TAX ACT OF 1981 AT THE LAST MINUTE BY LOBBYISTS.

FACT: SAFE HARBOR LEASING WAS THE CULMINATION OF AN EXTENDED EFFORT BY THE INDUSTRIES REPRESENTED IN THIS PANEL, AND OTHERS, TO OBTAIN TAX LAW AMENDMENTS WHICH WOULD PERMIT THEM TO UTILIZE THE INVESTMENT TAX CREDITS WHICH THEY WERE LEGITIMATELY EARNING, BUT WERE UNABLE TO USE AT THE MOMENT

BECAUSE OF LIMITED TAXABLE INCOME. WHEN THE TREASURY DEPARTMENT BECAME AWARE OF THE PROBLEMS OF THESE BASIC INDUSTRIES, AND THE FACT THAT PASSAGE OF THE ACCELERATED DEPRECIATION PROPOSAL KNOWN AS "10-5-3" WOULD TEMPORARILY HURT RATHER THAN HELP THEIR SITUATION, TREASURY DEVELOPED SAFE HARBOR LEASING AS AN ANSWER TO THE PROBLEM.

IT IS TRUE THAT, DUE TO TIME LIMITATION, SAFE HARBOR LEASING DID NOT RECEIVE ATTENTION FROM A LARGE NUMBER OF MEMBERS OF CONGRESS. THEIR ATTENTION IS NOW SHARPLY FOCUSED, AND I BELIEVE THAT A FULL REVIEW SHOULD REAFFIRM THIS APPROACH AS A SOUND METHOD OF ASSURING THAT THIS COUNTRY'S BASIC INDUSTRIES ARE TREATED FAIRLY, AND THAT FURTHER IT IS SOUND ECONOMIC POLICY FOR THE CURRENT RECESSIONARY PERIOD.

#5: SAFE HARBOR LEASING PERMITS A LARGE NUMBER OF PROFITABLE BUSINESS CORPORATIONS TO ELIMINATE COMPLETELY THEIR CURRENT TAX LIABILITY.

FACT: SOME PROFITABLE CORPORATIONS MAY HAVE ELIMINATED THEIR TAX LIABILITY, BUT FOR BUYERS THAT RESPONDED TO THE ARTHUR ANDERSEN STUDY, CURRENT TAX LIABILITY WAS REDUCED BY ABOUT 40 PERCENT. BUYERS DID NOT, HOWEVER, GET A FREE RIDE, AS THEY HAD TO PAY THE SELLERS RATHER THAN THE IRS. THE SELLING COMPANIES RECEIVE THE TAX BENEFITS INDIRECTLY THROUGH THE LESSORS, RATHER THAN DIRECTLY AS WOULD BE THE CASE IF ITC AND ACRS DEDUCTIONS WERE MADE REFUNDABLE ON THE PART OF THE GOVERNMENT. SHOULD CONGRESS WANT TO ELIMINATE THE POSSIBILITY OF BUYERS USING SAFE HARBOR LEASES TO ELIMINATE THEIR TAX LIABILITY, IT CAN EASILY BE DONE THROUGH A LIMITING PROVISION WITH RESPECT TO THE PERCENTAGE REDUCTION ALLOWABLE.

#6: SAFE HARBOR LEASING IS OF NO BENEFIT TO SMALL BUSINESS.

REALITY: AS BOTH TREASURY DATA AND THE ARTHUR ANDERSEN'S STUDY INDICATED, SMALL BUSINESS IS IN FACT BENEFITING FROM LEASING. HOWEVER, MANY SMALL BUSINESSES MAY NOT HAVE PARTICIPATED BECAUSE OF THE LACK OF KNOWLEDGE ABOUT THE PROVISION, SOMETHING THAT WILL BE REMEDIED QUICKLY, IF CONGRESS REAFFIRMS THE PROVISION SOON,

BY THE END OF 1981, BROKERS CATERING TO THE NEEDS OF SMALL BUSINESSES WERE SWINGING INTO HIGH GEAR.

UNFORTUNATELY, FEAR THAT CONGRESS WILL REPEAL OR SEVERELY RESTRICT SAFE HARBOR LEASING RETROACTIVE TO FEBRUARY 19, 1982, HAS PRETTY MUCH DRIED UP THE MARKET FOR SMALL BUSINESSES, INCLUDING FARMERS.

THIS PROBLEM COULD BE CORRECTED, MR. CHAIRMAN, IF THIS COMMITTEE WOULD INDICATE THAT ANY LEGISLATION WHICH MIGHT AFFECT SAFE HARBOR LEASING WOULD BE PROSPECTIVE RATHER THAN RETROACTIVE IN NATURE.

#7: REPEAL OF SAFE HARBOR LEASING IS SOUND ECONOMIC POLICY BECAUSE IT WILL HELP GREATLY TO REDUCE HUGE FEDERAL DEFICITS OVER THE NEXT FEW YEARS.

FACT: I SHARE WITH YOU YOUR CONCERN OVER THESE DEFICITS, BUT REPEAL OF SAFE HARBOR LEASING IN AN EFFORT TO REDUCE THEM WOULD BE BAD PUBLIC POLICY AT THIS TIME. WE ARE IN A SERIOUS RECESSION AND RECOVERY IS NOT YET IN SIGHT. REPEAL OF SAFE HARBOR LEASING NOW WOULD CUT A SIGNIFICANT

PART OF THE CASH FLOW AND THUS OF THE CAPITAL SPENDING BY THIS COUNTRY'S BASIC INDUSTRIES (THE SO-CALLED DISTRESSED INDUSTRIES WHICH THE ARTHUR ANDERSEN STUDY SHOWS ARE THE MAJOR BENEFICIARIES OF THE PROGRAM) AT A TIME WHEN CAPITAL SPENDING IS NEEDED TO SPUR RECOVERY FROM THE RECESSION AND TO CREATE JOBS. THESE INDUSTRIES ARE ALL IN TIGHT CASH POSITIONS, LESS CASH FLOW FROM LEASING MEANS ALMOST A DOLLAR-FOR-DOLLAR LOSS OF CAPITAL EXPENDITURES AT THIS TIME. IN ADDITION, AS MEMBERS OF THIS PANEL WILL EMPHASIZE, INVESTMENT PLAN CUTBACKS WILL RESULT IN LOWER PRODUCTIVITY GROWTH IN THE FUTURE.

LET ME SAY ALSO THAT I BELIEVE THE TREASURY ESTIMATES OF THE REVENUE IMPACT OF SAFE HARBOR LEASING FOR FUTURE YEARS MAY BE ON THE HIGH SIDE. EVERY COMPANY REPRESENTED AT THIS TABLE - AND I DARE SAY THE VAST MAJORITY OF COMPANIES ENGAGING IN SAFE HARBOR LEASING - INTEND TO BE PROFITABLE AGAIN BEFORE LONG. WE WOULDN'T BE MAKING THE INVESTMENT THAT GENERATES THE TAX CREDITS AND DEDUCTIONS IF WE BELIEVED OTHERWISE. WHEN WE ARE PROFITABLE, WE WILL BE ABLE TO TAKE THE TAX CREDITS AND DEDUCTIONS WHICH INVESTMENT GENERATES AND THE NET REVENUE LOSS ESTIMATED BY TREASURY WILL BE ONLY A MATTER OF TIMING.

I COULD GO ON MR. CHAIRMAN. BUT MY TIME HAS EXPIRED AND I HOPE I'VE SAID ENOUGH TO INDICATE THAT THE PUBLIC, AND PERHAPS EVEN THE CONGRESSIONAL PERCEPTION OF LEASING IS NOT AS FULLY AND FAIRLY DEVELOPED AS IT SHOULD BE BEFORE CHANGES ARE MADE. HOPEFULLY, THESE PROCEEDINGS WILL HELP TO GIVE A

BETTER UNDERSTANDING OF THE ECONOMIC DESIRABILITY OF THESE PROVISIONS. WE URGE THE COMMITTEE TO MOVE SOON TO CORRECT ANY DEMONSTRATED ABUSES THAT HAVE ARISEN WITH RESPECT TO SAFE HARBOR LEASING, BUT THAT THE BASIC THRUST OF THESE PROVISIONS BE RETAINED.

I NOW TURN THE MICROPHONE OVER TO MR. CHARLES DICKEY, CHAIRMAN, SCOTT PAPER COMPANY.

THANK YOU VERY MUCH!

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STATEMENT BY
CHARLES D. DICKEY, JR.
CHAIRMAN OF THE BOARD
SCOTT PAPER COMPANY
BEFORE
SENATE COMMITTEE ON FINANCE
March 18, 1982

Mr. Chairman and Members of the Committee:

Scott Paper Company is testifying today in support of Section 168(f)(8) safe harbor leasing provisions incorporated in the Economic Recovery Tax Act of 1981, approved by this Committee and later signed into law by the President. It is worthy to note that safe harbor leasing is the only provision of last year's tax bill that has any meaningful impact on Scott Paper. Furthermore, we know of no other legislation of greater importance to many of America's capital intensive industries than this and come before you to state our case and explain how safe harbor leasing is affecting our Company.

Scott Paper Company is one of America's oldest and best known pulp and paper companies. We employ 20,000 people directly and many more indirectly. In 1981 our total domestic sales equalled $2.3 billion. We make a wide variety of consumer and commercial paper products for the home, the office and industry as well as printing and publishing papers.

Within the past year we have embarked on the most aggressive capital spending plan in our Company's history. Scott plans to spend $1.6 billion over five years to expand capacity, modernize our plants, increase productivity and reduce our dependence on foreign oil. Capital spending for 1982 will be almost half a billion dollars, up more than 40% over last year and 80% over 1980. This capital program, which provides thousands of construction jobs alone, is the largest and most important project we have ever undertaken.

Both the magnitude and timing of our capital spending plan are related directly to safe harbor leasing. Either the repeal or a modification which would preclude our ability to participate in safe harbor lease transactions would force decisions to postpone indefinitely or cancel large parts of our capital plan equalling several hundred million dollars.

Scott Paper Company, along with many other major firms in our industry, has been an active seller or lessee in the leasing market. In 1981 we entered into several transactions involving millions of dollars of capital equipment in fourteen states* and received about $50 million in badly needed cash. The cash we received was immediately used to finance more projects. We have expected to participate in further transactions in 1982 and 1983 in the same magnitude. Importantly, the funds we plan to receive are an essential ingredient in financing our capital projects this year and next.

There are two basic facts which must be understood if one is to have a full appreciation of safe harbor leasing:

First-- Safe harbor leasing is nothing more than a financing mechanism. It provides companies like ours with the tax benefits we have earned as a result of capital spending. It is far superior to the old leveraged leasing rules and very efficient. It also tends to equalize access to tax benefits and incentives for all. If the safe harbor leasing law were not in existence, we would be denied access to our earned tax benefits.

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*Pennsylvania, Georgia, Delaware, Washington, New York, Indiana, Mississippi, New Jersey, Wisconsin, Alabama, Maine, Arkansas, California, Texas.

Second -- Safe harbor leasing is an integral and absolutely necessary part of the Accelerated Cost Recovery System(ACRS). Without safe harbor leasing, Scott Paper and many other capital intensive firms would have received no direct benefit and would be at an even greater competitive disadvantage as a result of the accelerated depreciation bill passed last year. To underscore this point, we computed the benefit of the "10-5-3" proposal. We determined that over a five-year period the accelerated depreciation proposal would have generated $250 million in additional deductions for Scott, while yielding less than $10 million in tax savings! The reason is simple: tax benefits generated from our capital program were exceeding our earnings capacity. From a competitive point of view, the accelerated depreciation proposal would have actually hurt us more than it helped. Compounding the whole problem was almost $50 million in Investment Tax Credits we could not use and were carrying forward. The leasing idea was born out of attempts to correct this problem and it has worked very well.

Let us all remember that the guiding purpose in passing this tax legislation was to spur capital formation and capital spending. Although the recession and high interest rates have combined to limit capital spending, the legislation is correct and it is working. The most serious mistake we could make now would be to repeal leasing. Scott Paper Company is a perfect example of how well it is working.

The Treasury Department, the Congressional Budget Office, economic advisors in both the Carter and Reagan Administration and many outside experts all agree that this leasing provision makes sense, especially in conjunction with ACRS. If it is repealed now, or if it is unreasonably modified, it will have severe consequences.

In any objective look at leasing, Congress must review the positive benefits and incentives it provides in terms of encouraging capital spending. Here are several factors to consider:

1. The greatest benefit is provided to the seller or lessee and not the buyer. The seller is the company who earned the benefit by undertaking capital projects. On the present value basis, sellers receive between 85¢ and 95¢ on the dollar for tax benefits transferred.

2. Safe harbor leasing acts to discourage tax-motivated corporate acquisitions and takeovers. As an example, Scott Paper could be a prime candidate for takeover by a major oil company, not only because of our land holdings, but also because of large accrued, but not used, tax benefits. In other words, without leasing, Scott would unwillingly be financing our own hostile takeover.

3. A review of the sellers will show that generally the competitive industries that are aided the most by safe harbor lease transactions are America's basic industries and those that are the most capital intensive with low returns on investment.

4. Safe harbor leasing promotes tax neutrality. It gives all companies equal access to tax incentives they have earned.

Scott Paper recognizes that there has been controversy concerning this law, and we are rather painfully aware that the market for lease transactions, so critical to our cash flow and 1982 capital plan, virtually evaporated after February 19, 1982. While both of these situations are most regrettable, they are also correctable. Since we cannot deal with the artificial suspension of the market we do offer some suggestions regarding the controversy.

The safe harbor leasing law is complicated as are many other financing tools. Initial press reports that sought to explain the basis for the law were incomplete, one-sided, misleading and apparently written more for their sensational value than to inform the public.

Nonetheless, there are, admittedly, several perception problems. Each, I believe, can be dealt with without destroying the inherent fairness and value of the tax law.

One perceptual problem, disputed I might add by the Treasury Department, is that small businesses and new start-up businesses have not fully benefitted from the law. We believe that there are no major barriers that preclude participation by small and start-up businesses and that the market is quickly adjusting to make these transactions possible. However, if it is essential to make further changes, these can be dealt with easily in several ways, either by opening up the law to permit closely held corporations to participate and/or by allowing any business to enter into at least $5 million in lease transactions without restriction.

A second perceptual problem is that some large and rich companies may be buying tax benefits to such a degree that they virtually eliminate much of their tax liability to the federal government. There are several ways to solve that problem as well. One way is to put a cap on the amount of tax benefits a company can purchase. This can be accomplished by prohibiting the purchase of tax benefits that reduce the buyers tax liability by more than a specified percentage.

An acknowledged third problem is the projected federal deficit. The Treasury Department estimates the revenue impact of safe harbor leasing in 1982 to be $3.2 billion.

That could be trimmed by a variety of techniques, but doing so would have most unsatisfactory consequences for the economy. It would cause the cancellation of capital projects and eliminate jobs associated with those projects. It would increase social support costs; and, it would reduce revenue opportunities for the government. By providing important incentives to America's distressed capital intensive industries, safe harbor leasing is an effective working force against the recession. Any adjustments in safe harbor leasing that would reduce capital investment should be postponed until the economy is restored to a healthy status.

We are anxious to work with the Committee to eliminate perceived abuses of the law, but we urge the Committee not to destroy this essential pro-capital formation and pro-capital spending law in the process.

There are some in the business community who have called for repeal or modification of safe harbor leasing. We believe that it is important for the Committee to evaluate their motivation.

Some in Congress have called for a review of leasing. We welcome a review because we know of no other federal tax policy for business working so well, so quickly.

In summary, it has been our experience that leasing has been working exactly the way it was intended to work. It has encouraged us to continue our largest capital program ever. It has provided equal access to tax benefits earned by capital projects. Its repeal would have an immediate and very negative impact on our Company. We urge the Committee to give its full support to policies that provide these incentives to capital intensive industries. The current economic recession serves to underscore the need for this equitable tax law.

STATEMENT OF
FREDERICK G. JAICKS
CHAIRMAN, INLAND STEEL COMPANY
CHICAGO, ILLINOIS
BEFORE
THE COMMITTEE ON FINANCE
MARCH 18, 1982

My name is Frederick G. Jaicks and I am Chairman of the Board of Inland Steel Company, an integrated steel business, headquartered in Chicago. Inland employs approximately 35,000 men and women and, in raw steel production, it is the seventh largest steel company in the United States. It has, for many years, been among the most profitable of the steel companies. It has reported profits every year since 1932.

Notwithstanding the fact that we have consistently reported profits, our profits today are inadequate. In fact, we actually reported a loss in the fourth quarter of 1981 and may be faced with that situation again in the first quarter of 1982.

Today's profits squeeze is the combined result of the state of the economy, the particularly depressed condition of several of our major customers, including the automobile manufacturers, and the impact of imported steel. We are clearly in a distressed industry during a distressed period.

My purpose today is to explain the practical importance of the safe harbor leasing provisions to Inland and to the steel industry generally in the present situation in which we find ourselves.

In order to return to acceptable levels of profitability and reliable employment, Inland and the industry need to move forward in a program of continuous modernization, to meet changing conditions and to take advantage of the efficiencies provided by technological advances. This is, of course, very difficult during a period of profits squeeze, with its inherent limitations on internally generated funds and restrictions on the amounts that we can prudently borrow.

Very large dollar investments are at stake. In Inland's case, the first phase of a major modernization program commenced in 1974 and was completed in 1980 at a cost of over $1 billion. The second phase of the program, as originally laid out, would have involved almost as much money as the first phase and would have provided new coke oven batteries, a major new finishing facility and increased continuous casting capacity. However, with the recession in the steel business which commenced in 1980 and which, after a brief upturn, returned and is still with us, we were forced to conclude that this expansion and modernization should be substantially cut back, at least for the present.

Thus, in 1981 our capital expenditure program was restrained and held to approximately $135 million. Similar restraints are being exercised in 1982.

The steel industry generally has similar massive requirements for modernization expenditures. Since November 1980, individual steel companies have announced modernization programs totalling more than $6.5 billion in capital investments. The struggle that will be required to justify and finance expenditures of this magnitude under today's operating conditions is obvious.

Inland and the steel industry vigorously supported the Economic Tax Recovery Act of 1981, particularly the ACRS incentive system, in the belief that it would aid saving and investment. But without the safe harbor leasing provisions, steel companies and other capital intensive businesses would be unable to use much of the investment incentives which Congress has provided because taxable profits from existing assets are insufficient to absorb the incentives generated by new assets.

Although Inland has been profitable in its financial statement, Inland's profits have not been large enough to absorb the investment credits generated by its prior huge investment programs. The combination of low operating profits for 1980 and 1981 and the incentive depreciation deductions allowed for tax purposes produced net operating losses for tax purposes.

I do not want to leave the impression that the need for safe harbor leasing is a recession phenomenon that will disappear with upswings in the business cycle. Congress has designed the tax incentives in such a way that their usability depends upon the ratio of new investments to taxable income. Companies with large amounts of new investments -- which generally include capital intensive companies, like steel -- are likely to have a chronic problem. Given the capital intensive nature of the steel business and the massive modernization expenditures that need to be made, Inland projects that even with more normal profit levels and a more robust economy, it will be a number of years before all the tax incentives it generates can be absorbed currently.

If the ACRS investment credit incentives are not available to Inland through safe harbor leasing or some comparable mechanism, Inland's investment program will inevitably be impacted adversely in major degree. The unavailability of the incentives has two similar but distinct effects:

First, inability to use the incentives restricts the funds which can be made available to finance new investment. We cannot build facilities for which we do not have money. Financing constraints are serious for many steel companies today, and are obviously accentuated by the recession. For companies with taxable income, the tax incentives provide an important cash flow. If we also owned a profitable unrelated company, for example, the investment credit alone would immediately provide 10% of the cost of a new steel facility. We can see in the market place that, in the aggregate, the incentive tax benefits provided by law may supply cash equal to 30% or more of the cost of the asset. If the incentives are available we can obviously do much more than if they are not available.

Second, inability to use the incentives increases our effective capital costs in comparison with others, which makes us and our products less competitive, further squeezing our profits. For example, in 1981, when it became clear that Inland would not be able to absorb its unused tax incentives currently, Inland's financial staff calculated that Inland's net capital cost for new facilities would be 30% to 40% higher than the net capital cost of similar facilities to a company that could use the incentives currently. If our costs are higher, our profits will obviously be less; and that prospect is an obvious deterrent to new investment. By entering into a safe harbor lease we calculated we could eliminate 70 - 80% of this excess capital cost, leaving us with not all, but most all, of the incentives provided by Congress to more profitable companies. Accordingly, Inland placed about $71 million of its 1981 additions in a safe harbor lease and received approximately $19,600,000 in cash. We were planning similar transactions in 1982, involving larger amounts of property. However, the announcement that the safe harbor leasing rules might be altered for transactions entered into after February 19, 1982, made everything uncertain and we were forced to delay our plans. That obviously does not contribute to economic recovery, but we had little choice.

It is relevant, I think, to relate one other fact about our 1982 capital investment program. One of the major facilities under construction is a new continuous annealing line, which will provide lightweight, high strength steel for the automotive industry. It will cost about $100 million. Several years lead time is often involved in constructing major facilities of this kind, and planning for this facility commenced in 1980 -- before safe harbor leasing. By then it was apparent that we might be unable to use the tax incentives provided. Under the circumstances we made plans to use a traditional "leveraged lease." That lease would have transferred the tax benefits of the asset to the lessor in return for a reduction in the rentals Inland would pay. Our financial people say that such leveraged leases have been a common transaction for many years. They perform the same tax benefit transfer function as a safe harbor lease. The same incentives are transferred to a lessor that can use them, but the lessor under the old rules would not be permitted to pass as much of the incentive back to Inland as under a safe harbor lease.

After the safe harbor legislation, we restructured the transaction. As restructured, we will still have a "leveraged lease." The lessor will purchase the asset partly with its own funds and partly with funds borrowed from a third party (rather than from Inland). But the lease will also qualify under the safe harbor rules (if they remain unchanged).

The point is that the principles of safe harbor leasing are not new, but have been with us for many years. In the case of the continuous annealing facility, cutting back the safe harbor provisions would not reduce the amount of incentives used, as the same amount of deductions and credits could be transferred under the old leveraged lease rules. It would simply reduce the amount of those incentives which would go to the lessor and be lost to Inland.

In summary, restrictions of safe harbor leasing would, in my view, force steel companies that cannot directly use tax incentives available to other companies to scale back important portions of their vital modernization programs. The cost, in terms of the nation's industrial strength and employment, particularly during a recession, would be substantial.

In urging the retention of safe harbor leasing, we do not ask for special favors. We simply ask that steel and other capital intensive industries in steel's position share in the same investment incentives that Congress has provided for companies that happen to have taxable income. That will permit companies like Inland to compete equitably for investment funds and to continue to contribute to America's economic vitality.

TESTIMONY OF

FRANK BORMAN

CHAIRMAN, PRESIDENT & CHIEF EXECUTIVE OFFICER

EASTERN AIR LINES, INC.

before the

SENATE COMMITTEE ON FINANCE

UNITED STATES SENATE

MARCH 18, 1982

I appreciate the opportunity to appear before the Senate Finance Committee to testify today on the vital importance of the safe harbor leasing provisions contained in the Economic Recovery Tax Act of 1981. My remarks understandably will focus on Eastern Airlines, but I speak also on behalf of other member airlines of the Air Transport Association.

The purpose of my testimony is to express my most serious concern over the possibility of early repeal of the tax transfer provisions allowed by safe harbor leasing. Without these provisions, the investment incentives of the accelerated cost recovery system will surely bypass many of the industries it was intended to stimulate.

For Eastern Airlines, repeal would put in question $1 billion worth of procurement, involving thousands of jobs throughout the nation. The ATA reports that for the airline industry as a whole there are 400 aircraft on order or option with a value of more than $15 billion, whose procurement could be cancelled or delayed if the leasing provisions are repealed. Clearly, repeal would have a drastic impact on fleet modernization that is necessary to increase productivity, create jobs and strengthen the competitive posture of the nation.

Let me say at the outset that I fully recognize the need to eliminate abuses, but I strongly believe there are situations where safe harbor leasing is essential to maintain or stimulate economic activity which otherwise would be lost at a net penalty to the economy of our country.

I am here to describe one specific case where safe harbor leasing would accomplish specifically what Congress intended when it acted last year to stimulate capital formation and investment on an equitable basis. This case involves Eastern and its order for the new technology Boeing 757 airplane. I want to make three points.

1. Eastern ordered the 757 aircraft at a time of profitable operations.
2. When the airline industry, together with many other industries, was hit by two successive recessions, inflation and high interest rates and sustained record losses, Eastern was forced to reconsider the 757 order.
3. Safe harbor leasing made it possible for Eastern to pursue its billion-dollar investment plan.

On February 23, 1982, I informed the Chairman and members of this Committee:

"As a member of an industry which has been severely buffetted by the introduction of deregulation and the current recession, the retention of the leasing provisions of the Act are absolutely essential -- if Eastern Airlines is to proceed with any assurance of consummating its planned purchase of new fuel efficient Boeing 757 aircraft over the next two to three years -- valued at nearly one billion dollars.

"At a time when increased investment and creation of jobs are urgently needed to get our nation's economy moving in the right direction, it would seem counter-productive to take action which -- in our case -- could produce the exact opposite result. If any changes are made, we urge that the basic concept of leasing be retained, particularly as they apply to industries like airlines."

The Boeing 757 aircraft is a new technology, narrow-body, twin engine, fuel efficient airplane designed for short to medium range operations with capacity for 185 passengers in Eastern mixed configuration.

In 1978, when the airline industry was achieving a satisfactory profit level, Eastern became one of the launching customers for this new aircraft. The 757 program is on schedule and the first flight of this aircraft took place on February 19 of this year. The FAA type certification is expected in December, 1982 or January, 1983.

Eastern has entered into firm purchase commitments for 27 Boeing 757 aircraft. Deliveries span a two-year period starting in December, 1982 and ending in December, 1984. The total estimated purchase price for these aircraft, before any spares provisioning, but including cost escalation, is $909 million. Exhibit A shows deliveries and prices by year.

The question could arise as to why a capital investment program committed in 1978 now is linked for its fulfillment to tax provisions enacted in 1981. There are two ways of answering this question. One, of course, is the unforeseen downturn since 1978 in the economy in general and the airline industry in particular. The airline industry sustained record losses in 1980 and 1981 and for the 12 months ending June, 1982, operating losses could reach $1 billion. Thus, given this situation, safe harbor leasing provides an urgently needed economic incentive by reducing the high risk of financial difficulties in the early part of a new technology program.

Boeing launched the program in 1978 with 40 firm orders for delivery in 1983 and 1984.

After almost four years, Boeing's order book for the period 1983 and 1984 has only increased by 17 units to a total of 57. Other orders have been received but for years subsequent to the important start-up period. Exhibit B provides information concerning Boeing 757 orders.

I want to emphasize that when Eastern became a launching customer for the 757, Eastern was completing a record profit year, its third consecutive profitable year. Eastern's financial plan, as stated, was based on achieving a minimum 2 percent profit margin on revenues. This expectation was judged reasonable and conservative, especially as this minimum profit objective is supported by an employee variable earnings program. Further, Eastern obtained a $400 million revolving bank credit commitment in 1980 to provide additional insurance in financing the commitments of the B757 program.

Unfortunately, the initial profit expectations have not been materializing (as shown in Exhibit C) reflecting a downturn in earnings which is widespread in the airline industry. Exhibit D shows earnings for the major airlines for the calendar year 1981 where Eastern ranks sixth out of a total of 12 carriers in terms of net earnings margin on revenue.

Combining developments at Boeing and Eastern, the situation today finds Boeing with a minimum level of orders and Eastern facing difficult capital markets.

The second reason why the B757 situation is particularly illuminating as to the criticality of safe harbor leasing relates to the fact that Eastern did not pursue the restructuring of the program in 1981 because of the Congressional action on safe harbor leasing.

Confronted with economic realities, in July of 1981, I met with management of the Boeing Company to review the need to restructure the program. When safe harbor leasing was adopted, a new element was brought into the financial planning of the program and discussions relating to restructuring it were discontinued. In short, safe harbor leasing made it possible for Eastern to go forward with the order. The situation today is markedly different. Boeing is totally unable to restructure the program, and if safe harbor leasing is repealed, Eastern's ability to proceed with any assurance of consummating its planned purchase of these Boeing aircraft is open to question. In summary, we relied in our planning on the leasing provisions of the Economic Recovery Tax Act of 1981.

I believe that the leasing provisions will accomplish the purposes Congress intended. If there is a need to modify this legislation to prevent abuse, then changes should be made, but repeal would have drastic consequences for capital intensive industries, such as the airlines, and would result in the loss of scores of thousands of manufacturing and other jobs throughout the nation.

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EXHIBIT A

EASTERN'S COMMITMENT

($ IN MILLIONS)

	1982	1983	1984	TOTAL
NUMBER OF AIRCRAFT	2	11	14	27
AVERAGE UNIT PRICE	$ 29.8	$ 31.8	$ 35.7	$ 33.7
TOTAL COST	$ 59.6	$349.6	$499.7	$908.9

EXHIBIT B

EASTERN'S B757 ORDER IS OF VITAL IMPORTANCE TO THE EARLY PART OF THE BOEING PROGRAM...

	DELIVERY DATES			TOTAL FIRM ORDERS
	1983	1984	AFTER	
LAUNCHING ORDERS - IN 1978				
EASTERN	11	10	-	21
OTHERS	11	8	-	19
TOTAL	22	18	-	40
FIRM ORDERS AS OF MARCH 1982				
EASTERN	13	14	-	27
OTHERS	17	13	64	94
TOTAL	30	27	64	121

EXHIBIT C

PROFIT EXPECTATIONS ARE NOT MATERIALIZING........

($ IN MILLIONS)

	PROFIT/(LOSS)		
	1978 EXPECTATIONS	ACTUAL OR NEW ESTIMATES	IMPROVEMENT/ (DETERIORATION)
1978	$ 59.1	$ 67.3	$ 8.2
1979	42.1	57.6	15.5
1980	52.5	(17.4)	(69.9)
1981	60.0	(65.9)	(125.9)
Sub-Total 1978-1981	$213.7	$ 41.6	$(172.1)
1982	68.0	?	?
1983	74.8	?	?
1984	82.3	?	?

EXHIBIT D

1981 AIRLINE PERFORMANCE

EASTERN'S EARNINGS EROSION IS CHARACTERISTIC OF THE INDUSTRY AS SHOWN BY THE FOLLOWING 1981 DATA FOR THE 12 MAJOR AIRLINES...

($ in Millions)

RANKING BY NET MARGIN	AIRLINE	REVENUES	NET INCOME (LOSS)	NET MARGIN
1	US AIR	$1,110.5	$ 51.1	4.6%
2	DELTA	3,638.6	91.6	2.5
3	AMERICAN	3,915.0	47.4	1.2
4	NORTHWEST	1,843.9	10.5	.6
5	TRANS WORLD	3,420.4	(25.1)	(.7)
6	EASTERN	3,727.1	(65.9)	(1.8)
7	UNITED	4,541.7	(104.4)	(2.3)
8	REPUBLIC	1,448.4	(46.3)	(3.2)
9	CONTINENTAL	1,079.3	(60.4)	(5.6)
10	WESTERN	1,059.8	(69.4)	(6.5)
11	PAN AMERICAN	3,574.4	(397.9)*	(11.1)
12	BRANIFF	1,214.2	(160.0)	(13.2)
	TOTAL	$30,573.3	$(728.8)	(2.4%)

* Excludes sale of hotel properties.

The **Chairman**. I would say with reference to the study, I am aware of that study. We haven't had a chance to review it; we are in the process of doing that. I am not suggesting it is not accurate; I am suggesting there may be a difference of opinion in some areas, so I don't think it is necessary we go into that.

Senator Byrd?

Senator **Byrd**. Thank you.

I think each of you made a good presentation from the point of view of the current tax proposal.

Let me ask you this—I don't know exactly to whom I should ask it, but anyone—this was not a part of the President's original tax program. What was the genesis of this safe harbor leasing provision?

Mr. **Seidman**. I believe I could answer that, Senator, since I participated in part of it.

When the companies represented here and others took a look at the President's program, they saw, as Mr. Dickey has pointed out, that for the basic industries there simply was going to be no benefit and, as a matter of fact, some detriment.

We went to the Treasury Department and met with their people, pointed it out, asked them to run some of the numbers. They agreed with that, and as a result of that the administration, in order to make the benefits spread throughout industry, came up with the safe harbor leasing provisions. And that's the background of how they got into the law.

Senator **Byrd**. I think it was 3 or 4 months, or maybe even longer, from the time the President's original proposal was submitted until this provision was recommended.

Mr. **Seidman**. Yes, sir, that's right. That was the period during which we were all examining our own situation and responding to the President's program. And the response was that the basic capital-intensive industries were not going to receive any benefit. And the administration, as I understood it, intended that they should. And, therefore, they recommended safe harbor leasing.

Senator **Byrd**. I realize, of course, that none of you wish to have any changes made; but let's assume for the moment that there will be modifications. Do you have any problem with Senator Dole's February 19 date?

The **Chairman**. Would you rather have it January 1?

Mr. **Borman**. That reminds me of the story about, "Other than that, Mrs. Lincoln, did you enjoy the play?" [Laughter.]

The February 19 date completely stopped all financial activities from our standpoint, because Senator Dole was very adamant about his concern for the abuses and his statement that this would be the date from which all changes would be effective. So we simply have not been able to do anything.

Senator **Byrd**. So as far as you are concerned, if the Congress is going to make a change, that date would not affect you any more than making it April 15?

Mr. **Borman**. Well, if the date were changed—I am not speaking for the panel but from our standpoint—we could at least go forward with trying to secure leases, and then make the change after whatever action you might take. I would prefer that, because right now we are just in jeopardy. And I have a $600 million problem that is severe.

The CHAIRMAN. We have a $150 billion problem.

Mr. BORMAN. Well, that's my problem, too. And I think that this would help solve the $150 billion. I really believe that it would.

Mr. JAICKS. Senator Byrd, I think my answer would be that if the Congress does determine that additional revenue is required, it should raise it in an evenhanded way. And it seems to us, at least as we look at our business futures and our business requirements, that this is really a very narrow and very disastrously harmful approach to one particular group of taxpayers, and a group that I think people generally realize from the point of view of employment and world competition is in need of the kind of benefits that were really kind of the centerpiece of the whole program that was enacted last year.

Mr. DICKEY. I might just add one thing to what Fred has just said.

The focus in this country and the focus in the Congress and the focus in business, and really by a great many people right across the Nation, for the last 3 or 4 years has been the need for capital formation. And capital formation really is nothing more than capital expenditures in new plant.

I think it has been generally accepted that this is essential if this country is going to survive, if this country is going to be competitive. The problem is, as you know, forgetting all about earnings, when you look at the end of the year and see how much cash you have got left over. And that's the important thing. You don't have enough cash to modernize your plants, to build new plants, and to do all the things that are essential. And that's what led to the accelerated cost recovery system, which we applaud.

But if you believe in the accelerated cost recovery system, and if you believe in the things that come out of that, then you have to believe in safe harbor leasing. Because without safe harbor leasing the people that probably need the accelerated cost recovery system the most are the smokestack industries and the very capital-intensive industries, many of which are represented right here. Thus, if you take away safe harbor leasing, you take away anything that they were going to get out of that depreciation reform, and that is extremely critical.

Mr. DICKEY. If I could make just one more comment on the February date. In our own case we had planned on safe harbor leasing and we have let contracts which will be financed by that. Now, we have currently put them on hold, because we know we will not be able to complete those contracts without it leasing.

So at the moment it is very difficult to try to plan and to run a business especially a capital-intensive business when the rules get changed, and retroactively, at that.

Thank you.

The CHAIRMAN. Well, not retroactively, I might say, just because that date's been raised. It would seem to me that there have been bills introduced calling for a January 1 date which was retroactive. I suggested the date I made the announcement that it would be that date, so there wouldn't be that problem; the theory being that if in fact the Congress was going to do something—and we are—

because safe harbor leasing is going to be modified or repealed, taxpayers should be on notice. If we could save $1 billion in the process, we ought to do it and not delay it and let everybody get in under the wire. Had I delayed the announcement we might have found that we had not saved any money because everybody had made the deal. I don't believe there is any secret about why it was done.

Senator Boren?

Senator **Boren**. Well, Mr. Chairman, on that point, I want to commend you for making the statement that you made and for setting that deadline, because I think it did stop the abuse that was going on and stopped it then, and we would have had an even more massive revenue hemorrhage. So I think you acted responsibly; I'm glad you did it, and I hope we can act as quickly as possible to either repeal or very substantially modify this provision.

I am shocked at the statements that have been made here today that this is working the way it should be, working the way it was designed to work. I can only say that I have been giving the benefit of the doubt to those who worked to get this accomplished and to the administration and others who have been defending it and saying, "Well, surely the abuse of it was not intended and not foreseen."

So I guess what we are dealing with is an intentional monumental ripoff as opposed to an unintentional one, and I don't see how it can possibly be defended.

I would just like to share with you a very real problem I have. We have to deal, as I said earlier, with the perception of fairness as well as with fairness itself in terms of trying to get the people of the country to unite behind an effort to balance the budget, get the deficits down, and take care of the inflation and the interest rates and other things that are really underlying the problems that all of you are having in your own business operations.

Without being overly dramatic, I can tell you exactly the kind of situation that those of us who are elected to office are faced with. The other day I was making a speech at a senior citizens' center in Chelsea, Okla. When I finished a lady came up to me who was about 80 years old—and this is an actual case; I am not drawing it to make it an overly sentimental situation, but it's true. She called me aside. I had been talking about the budget deficits, how we had to do something. She said, "I've been figuring." And she said, "I think that I could afford for you to cut my social security check by $10 a month." Now, this is actually what she said to me.

I said, "Well, do you mind? Let's talk over here privately in the corner." We went off to the corner, and I said, "I hope you don't think I'm nosy, but do you have any other source of income besides your social security check?" She said, "No."

I said, "What are your resources, your total resources for the month?" It was approximately $240 a month. She had no other family members—no children, and her husband was deceased.

She said, "Well, I just sat there while I was listening to you, and I figured this out." She said, "Now, my utility bill last summer in the heat ran about $100 a month." She said, "I don't have a car anymore. My prescription medicine runs about $40 or $50 a month. So that's $150 in some months, and I've got $240."

She said, "I don't buy new clothes very often, and I'm careful about what I buy at the grocery store." And she said, "I think I could give up about $10 a month in my check if it would help you balance the Federal budget, but I couldn't give up any more."

Now, that's an actual attitude, a very commendable attitude, and I don't think an unusual attitude on the part of a lot of citizens out there.

Then they pick up the paper and they read this: "GE Gets Tax Refund on Billions Profit"—this is right from the newspaper, and I read Mr. Edsel's report:

> General Electric, which had pretax earnings of $2.66 billion in 1981, capitalized so successfully on the bill Congress passed last year, letting corporations buy and sell tax breaks, that it will get a net tax refund of $90 million to $100 million from the Federal Government.

And then it also cites the example of Amoco which had $3.46 billion and was able to reduce its Federal tax liability—now, they still paid some taxes, but they reduced their liability—by $159 million through tax leasing.

Now, I haven't seen the lady that came up and made that kind of voluntary statement to me about what she was willing to do. But I think we have to face this. Here we are—we are trying to unite the people behind this effort. Now, what should I say to her? Should I say, "Well, that is working exactly the way it was intended"?

These very profitable companies—and I know that you have problems. And I am sympathetic to trying to find some way to modify this provision or to look at something else, be it refundable tax credits or something else. There may be a lot of problems with those, too. But I think we shouldn't just come in here and say, "Well, this is working as it should; it doesn't even need any modifications."

We could go with the example of Amoco again, and here they are. There is another article in the Wall Street Journal recently reporting that they were cutting back on their exploration and their development plans because they just didn't think they had the cashflow to do it. And they have used significant amounts of cash to buy tax breaks, in essence, to reduce their tax liability by $159 million. It appears we are even encouraging companies to forgo what would be productive investments in order to use their cash resources to buy up these tax breaks.

How do you answer this kind of situation? Suppose that lady comes back to me and says, "Now do you still really want me to give up $10 a month so I can help GE get a refund of $100 million?" That's a practical problem. We are asked that question. You may not be, but I am asked it. I am asked it in every community meeting I have. Now, how do I answer it?

Mr. **Seidman**. Well, Senator, I don't think it's easy because it's a complicated area. I know you are much better at handling that than I would be. But the facts of the matter are——

Senator **Boren**. I can't handle it. I have to just tell them I think it's wrong; there must be a better way.

Mr. **Seidman**. To the extent I can, I would say that those articles imply that GE or the other companies got some huge windfall and that they came out ahead by hundreds of millions of dollars as a result of this provision. That simply is not true. They have merely paid us distressed industries instead of having it go to the Treasury and back to us this way. Their net gains, as our report shows and even the joint committee's report, which I would question the numbers, shows that the vast majority of these benefits went so that perhaps a new plant in her town could be expanded, and perhaps social security could be paid by companies so that her social security check would be good.

It is simply not as simple as those headlines, and I think that has misled a great number of people. And I would hope that all of us would try to at least get those facts straightened out.

Well, let's just stay with that for a minute. All of the benefits are not going to the distressed industries. That part of it just is not true. We had an analysis, for example, of a transit authority which sold some tax breaks. It was calculated that for each dollar of railcar equipment subject to this agreement, 34 cents of tax benefits were created, 24 cents went to the transit authority, 10 cents went to the very healthy company. They did not need additional tax breaks; it was very profitable.

It did not go to a distressed industry. It did not go to an industry in trouble like yours, it went into the profits of a very profitable industry. Now, how do I justify that 10 cents to this lady I am talking about? That's the question. How do I justify that?

Mr. **Borman**. Senator, it's true that some of the benefits go to healthy industries. As you pointed out earlier, it is about the equivalent of a tax-free municipal bond. But under leveraged leasing, far more of the benefits flow to leasing companies and profitable industries. This has been the finest mechanism to do it.

Coming from your point of view, I would expect you to oppose all investment tax credits and accelerated depreciation. And if you feel that strongly about, say harbor leasing, then I would expect you to oppose it all. Because all we are saying is, you have tilted the playing field enormously if you abandon safe harbor leasing.

Senator **Boren**. There is no other mechanism of providing—there is no other mechanism at all that you can think of or devise that would direct the tax benefit back to those who cannot take advantage of ACRS because they are not generating income at this point? There is no other alternative but this? There is no other way to do it?

The **Chairman**. Could we get to that in the next round?

Mr. **Jaicks**. Could I add just one more comment, Senator?

The **Chairman**. Yes.

Mr. **Jaicks**. I would just like to say, looking at the history, that Congress in 1969, for the same reasons given for the repeal of safe harbor leasing, repealed the Investment Tax Credit with a catastrophic result. It absolutely stopped the economic recovery of business. Two years later the Investment Tax Credit was reinstituted. I just wonder whether we have 2 years of grace to go through that same routine again?

The **Chairman**. Well, I might say that is one reason I thought we had better address it early on, so that you wouldn't have that uncertainty.

Mr. **Dickey**. Senator Boren, there is another means, and that is refundability.

The **Chairman**. Well, that's not a means. [Laughter.]

Mr. **Dickey**. If you recall, it has been discussed. Maybe it's a naughty word, but that it has been discussed.

Mr. **Borman**. It doesn't take the accelerated depreciation into account.

The **Chairman**. Let's see; who is next? I guess Senator Mitchell, then Senator Chafee, then Senator Bentsen, then the chairman.

Senator **Mitchell**. Since it is apparent that the objections in the press reports all go to introduction of the third party, the buyer-lessor—the profitable corporation that gets the tax break—and the objections do not go to making the benefits available to those companies that need them, of the type represented here today, it seems to me that we should explore our outstanding chairman's dismissal of the——

The **Chairman**. I didn't dismiss it; I just said I wouldn't vote for it.

Senator **Mitchell**. As we have seen, with respect to your February 19th statement, your statements carry a great deal of weight. So we would at least like to explore it. And I would like to ask you to comment on it.

They're really fighting an uphill battle as seen from these stories is that that is a widespread perception. Some of us agree that is not only a perception; but if it is based on reality, I would like to have you comment. What are the alternatives? Is refundability as helpful to you? If not, why not? Can you not, with all of the resources, with the intelligence represented here in your organizations, come up with some alternative that meets the objective but doesn't have the baggage that this program carries with it?

Mr. **Dickey**. Senator Boren talked about abuses, and I am in no position to know the extent of so-called abuses. I am only in a position to talk, really, about my own company, and I see no abuses at all from our standpoint.

If there are abuses, and if you are aware of abuses, I am sure that there are ways to modify this legislation so that those abuses could be corrected. But I beg you not to correct them by killing the whole thing; because by so doing you are going to destroy and seriously impair a lot of very, very important industries in this country.

It gets back to the point that Frank Borman made, and that is that if you really believe in the things that I think that the Congress believed in and I think that the people in the country believed in, and that is the necessity for doing something about capital formation, and it proves out in the United States, then safe harbor leasing is an integral part of that.

Senator **Mitchell**. Are you saying that you don't think the refundable credit would be of benefit to you?

Mr. **Dickey**. No, I didn't say that. I just said that I didn't think it was a practical suggestion.

Mr. **Seidman**. Senator, could I make two comments? One, the refundable credit only deals with the Investment Tax Credit portion of the incentives and not with the accelerated depreciation, so while it is beneficial it is not nearly as beneficial as it would be if we went another way.

As far as abuses go, if it's the headline that says that X company has eliminated its taxes, and so forth, I think it would be relatively simple to put a limit on how much safe harbor leasing any buyer could do.

From the point of view of your ultimate objective, unfortunately, that tends to make the price lower to the seller because there will be less buyers. But there appear to be an adequate marketplace out there, and certainly the kind of headline that says so-and-so has gotten a carryback or eliminated his tax liability could be taken care of relatively easily without jeopardizing the fundamentals that these gentlemen are talking about.

Senator **MITCHELL**. I noticed Mr. Dickey made that suggestion both as to a specific dollar cap and the reduction of tax liability by a specified percentage.

Do you have any suggestions, Mr. Dickey, or anybody else, on what those amounts of percentage might be?

Mr. **DICKEY**. No; I really don't, Senator Mitchell. It would take study. But I totally support the principle.

Mr. **BORMAN**. We do also, sir, and we have made a recommendation to the committee staff on certain numbers and parameters on it.

But, again, in corroborating Mr. Dickey, I think in our case, with the 757 purchase, the program is working exactly as you intended it. We certainly don't see any sense of abuse here.

Senator **MITCHELL**. Well, I think the point Senator Boren was trying to make was that it is working as to the companies who are intended to be the beneficiaries, that is the seller-lessees. But it is providing an unwarranted benefit to buyer-lessors who use it, obviously, as a mechanism to reduce their tax liabilities.

Mr. **BORMAN**. Well, then, the approach that we suggested if you feel that strongly about it is to put some limitations on the amounts that they could offset their taxes.

Senator **MITCHELL**. Do none of you feel that there is a problem either in reality or in perception with respect to the GE story? Do you feel that anybody who is concerned about that, that that concern is unwarranted or unjustified in terms of equity?

Mr. **BORMAN**. I can understand very much your concern about the perception of it and Senator Boren's concern about it. On the other hand, I think that it makes sense for the person who wants to give up 10 percent of their social security. I think it's in the best interests of the country. I really do, from the standpoint of capital formation in our industry that has been severely affected by all kinds of different forces that I enumerated for you. And the strange quirk is that some of the new entrants after deregulation were able to go out and get federally guaranteed loans to buy new airplanes.

We are not asking for any of that, but, nevertheless, I do believe honestly that it is in the best interests—and I also recognize the perception problem you have. And I would suggest that a modification be required, you put some limitation on the buyer's ability to offset taxes.

The **CHAIRMAN**. Senator Chafee is next.

I might just say for the members of the committee here that we have the Joint Committee working on options. Right now we are up to 43 options. So there is an option for everyone. They will be before our committee, hopefully, next week some time, or at least in a private session, to go over some of the options.

I have never indicated in my statements that I thought it was an abuse; because if the program is there, it may be too generous, but if people are using the program as outlined, that is not an abuse as I view it. If it is too generous, the provision should be modified or repealed; that's a decision we need to make.

Mr. BORMAN. Senator, may I say something, sir?

The CHAIRMAN. Yes.

Mr. BORMAN. If you decide that it's too generous, well then I suggest that you must decide the accelerated depreciation and the investment tax credits are too generous, too. You know, somehow this has come out as a subsidy for unprofitable companies. It's not that at all; it's a matter of equity.

The CHAIRMAN. Well, I think there are some who think those are too generous, too.

Mr. BORMAN. Well, I would suggest that from the standpoint of creating jobs and getting the economy going again, they are far from too generous.

The CHAIRMAN. Our first witness this morning indicated that nearly everything was too generous—the AFL-CIO.

Mr. BORMAN. They have as much to lose from this as anyone.

The CHAIRMAN. That's what I thought.

Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

As I get the picture here, this committee and this Nation are dedicated to strengthening the industrial capacity of the Nation to compete. Because of this commitment, we passed an accelerated depreciation program last year.

Now we have reached the situation involving companies that aren't making any money or aren't making much money, as represented by you gentlemen here today.

Now, the problem is how do we encourage you to modernize? The only way you can get these safe harbor leasing advantages is if you modernize. You must buy the equipment. But you have nothing to depreciate against because you don't have any profits.

I think we agree that we do want this level playing field. We want a company which is investing to be modern to be able in some way to get the advantages of this investment. We are not just subsidizing some company that is going broke, because you only get the advantages if you go out and buy 757's or new machinery in the papermaking business.

So we are confronted with a very difficult problem. Presumably, if you go out and modernize, you are becoming more competitive and are creating jobs both in the purchase of the equipment and in the more modern plant which you are operating. We then, can compete with the Japanese or whomever it might be.

So far, this is all right, but the perception of the abuses, is not, I believe, that Eastern, Scott, or whomever has these credits and is selling them. The public perceives the abuse that the buyer is whittling down his taxes. If you don't have a buyer there to buy the credits, and obviously they only buy them because their taxes will go down, we would not go very far.

I am confronted, with the rest of the members of this committee, with the difficulty of justifying changes in our tax program or reducing expenditures. There is a lot of talk about reducing the cost-of-living adjustments or eliminating, postponing, or reducing in half the individual tax cuts.

Now, to my way of thinking, the principal abuses arise in reading that Occidental Oil or somebody is paying no tax. Perhaps the point Mr. Dickey makes on page 5 of his testimony and the others have referred to it here is that there are several ways to solve the problem. One is to put a cap on the tax benefits or a limitation. Another is to eliminate the possibility that a business can go down to zero tax liability.

Now, as you know, we are considering here a minimum tax on corporations.

Mr. Seidman, let's pursue the point you were making that if Congress puts a cap on there would be fewer people out there buying the credits or leasing them. But you say there are enough out there anyway. So, you think that's a route we might follow.

Mr. **Seidman**. I believe it's a possibility. Yes, sir, Senator.

Senator **Chafee**. Do you agree with that, Mr. Borman?

Mr. **Borman**. Yes, sir.

Senator **Chafee**. Well, I think we are faced with a real quandary here. It's too complicated to just say we'll do away with leasing. If we do away with it, we will certainly inhibit many of our companies from investing in more machinery and equipment, which is the objective of the whole accelerated depreciation program.

While I appreciate the testimony you have given, it has compounded our difficulties here—if I should thank you for that. [Laughter.]

The **Chairman**. Maybe we can lease them to someone. [Laughter.]

Senator Bentsen.

Senator **Bentsen**. Thank you very much, Mr. Chairman.

I won't take a back seat to anyone on this committee for having worked for accelerated appreciation of capital formation. I have been doing it a long time. Thus, I think it is absolutely critical for our country to be productive and competitive.

But I am also the fellow that had the only amendment in to knock this out—knock out the sale of tax credits. I couldn't get much support for it because it wasn't very well understood at the time. Treasury had an estimate in of a very small loss in revenue. It has gone far beyond that.

I was against it not because I don't understand what you are talking about, Frank Borman, and the need to try to make the playing field level, but because I put a higher priority on the confidence in the tax system. I don't believe we can get over that hurdle.

This country has had a benefit of a taxpayer compliance for a long time, far above other nations of the world. I can think of another nation not too far from here where a lot of the corporations keep three sets of books. They keep one for the government, another set for their partner, and a third set for themselves.

I read in the morning paper that tax evasion is going up in our country—not tax avoidance, tax evasion. And it's of deep concern to me. And I don't think we can get over the hurdle of a situation where we have most of the profitable companies in this country apparently paying no taxes, even though they paid to get that tax credit, and I understand that. I don't think we will ever get it explained and understood.

So I sure think we had better be looking at options. And I never was for refundable tax credits, but I am beginning to move and getting somewhat more sympathetic to the problems that you have expressed to me.

I also know that the investment tax credit is also, then, applicable to the small businessman. This one really doesn't work very well for the small businessman, with the amount of attorneys' fees and accountants' fees that you have to pay.

So I am ready to look at some alternatives, but I don't think this one is going to stay. I just don't think it can, because I don't think we can ever get the average Joe paying taxes to understand it and get him to feel it is fair.

Thank you very much.

The **Chairman**. Senator Bentsen, thank you.

Governor Winter was supposed to be ahead of this panel. He has been patiently waiting in the backroom with Senator Stennis. I thought, if it was all right with the members of the panel, he might come in and make a brief statement. We are checking to see if that is satisfactory.

Mr. **Jaicks**. Senator Dole, could I make just one comment to your earlier comment and to Senator Bentsen's comment?

The **Chairman**. Yes.

Mr. **Jaicks**. I happened to bring with me the cost to lawyers and brokers in our case. We sold some $71 million worth of tax credits last year, got $19,600,000 worth of cash, for which to brokers and lawyers in all of those lease transactions we spent $203,000, or 1.03 percent of the total—half or less than half of what Senator Dole's data indicated at the outset.

The **Chairman**. For Senator Matsunaga and Senator Symms, who have just entered the room, if we could let Governor Winter make his statement—Senator Stennis and Governor Winter have other obligations—I would let Senator Stennis do the honors in introducing the Governor.

Senator **Stennis**. Thank you, Mr. Chairman.

Mr. Chairman, we appreciate this courtesy.

Governor Winter, our Governor of Mississippi, is appearing here on behalf of the National Governors' Association, gentlemen, in reference to revenue bonds. In addition to being a Governor, he is an expert in this subject with a long experience in a law practice and otherwise. He has an outstanding record, and I am delighted and honored, too, to present him to this committee.

STATEMENT OF HON. WILLIAM WINTER, GOVERNOR, STATE OF MISSISSIPPI, ON BEHALF OF THE NATIONAL GOVERNORS' ASSOCIATION, WASHINGTON, D.C.

Governor **Winter**. Mr. Chairman, I greatly appreciate the opportunity to appear today. I recognize the time restraints under which the committee is operating, and I shall make my statement very brief.

I do have a prepared statement that I would like to file with the committee. This is a statement that I make on behalf of the National Governors' Association. It is a statement pursuant to a resolution adopted at the recent meeting of the National Governors' Association; and, Mr. Chairman, I believe I had the privilege along with three or four of my fellow Governors of bringing that resolution to you and presenting it at the time of its adoption.

The subject of industrial development bonds, of course, is one that has been discussed many times in many different forums, from many different points of view. Little of what I shall say here today will be new.

But I want to emphasize this, from the point of view of one Governor: I shall speak now as the Governor of Mississippi and not necessarily as the representative of the National Governors' Association—not that I am separating myself at all from the official position of the National Governors' Association or from the statement that I have filed with the committee.

I represent the State where the concept of tax-exempt industrial development bond financing originated. It originated for a very good reason, and a reason that is still very valid; that is, that there weren't enough jobs to go around in the State of Mississippi in 1937 and 1938 when Gov. Hugh White created the first industrial development bond program. The result of that has been the creation of hundreds of thousands of jobs in the State of Mississippi that would not have been created had tax-exempt financing not been available.

Now, that situation still prevails, and it prevails, very frankly, to a very substantial extent now by virtue of the high interest rates.

I serve as chairman of the Board of Economic Development of the State of Mississippi. This is the agency that is charged with the responsibility of overseeing the issuance of tax-exempt bonds. No tax-exempt bonds are issued in my State except through a process where a certificate is issued by the Board of Economic Development. And we oversee every single issue. We examine those issues to determine if the public interest is involved, if in fact the issues will create new jobs. And I can tell you authoritatively that about the only game in town right now in my State, as far as job creation is concerned, is the program that is based on tax-exempt financing. Most of the entities, most of the companies, coming to us for industrial development bonds are coming because they simply cannot get into the market and pay the interest rates that are required to be paid in order to finance new or expanded construction.

So, Mr. Chairman, I think for the relatively small amount of investment that the U.S. Government would be making by continuing an exemption process, you are going to get back substantial returns in increased taxes from those who have been put to work. The numbers that I have had presented to me indicate, maybe, a net loss to the Government at the present time of $200 million. That is really peanuts compared to the massive injection—direct injection—of Federal funds into the economic development program that we have seen in the past and which are now being curtailed.

I say to you and members of this committee, I hope that you will look very, very carefully at the industrial development bond program as a means of infusing new life into our economy, preserving the basis of job creation, and enabling States like Mississippi to stand on our own feet, raise our per capita income.

We are dead last. We need to raise our per capita income so that we will not be dependent on social programs to the extent that we have in the past. I regard the industrial development bond program as one of the essential elements in that building program. It has worked very, very well in my State. Most other States have now adopted it.

Admittedly, there have been abuses in it. I do not come here and ask to be excused for those abuses. I vetoed last year, Mr. Chairman, $150 million worth of industrial development bonds—local and private bonds—simply because I felt they did go beyond legitimate purposes of industrial development bonds.

Putting proper limits on the bonds, in my opinion, is one of the things that this committee should look at. But, for goodness sake, do not eliminate the very workable program that we have going now. Do not put unreasonable limitations on these bonds. Do not make us make a choice between accelerated cost recovery and industrial development financing. Do not put unreasonable capital investment limits on the bonds that we have access to.

With reasonable safeguards, the industrial development bond program, in my opinion, can serve this country and the States of this country well for many years to come without creating undue financial problems for the U.S. Government.

The **Chairman**. Thank you, Governor Winter. Your entire statement will be part of the record.

[The prepared statement follows:]

PREPARED STATEMENT OF HON. WILLIAM F. WINTER, GOVERNOR OF MISSISSIPPI

I am pleased to appear today on behalf of the National Governors' Association (NGA) to discuss the use of tax exempt financing by State and local governments. I am here as the Vice Chairman of the NGA Committee on Community and Economic Development.

All of us know that the country is in a serious recession. Economists predict declines in the nation's Gross National Product in the first quarter of 1982 at annual rates of up to 4.7%. Estimates are that capital spending by business may drop as much as 4.5%. The Congressional Budget Office (CBO) expects interest rates to resume their rise during the economic recovery forecasted for the second half of 1982.

Nationwide housing starts dropped below 1.1 million units for the first time since 1946, and these low figures are likely to continue through 1982 as interest rates remain high.

Treasury Secretary Regan and Commerce Secretary Baldridge have recently predicted that the current recession will drive unemployment to as much as a 10% national rate this year, the highest level since World War II. The Labor Department recently reported that 19 States already had unemployment rates in excess of 10% in January.

The federal and State governments must work in partnership to bring our country back on the road to economic recovery. Both Congress and the Administration have called on the States to take on added responsibilities for community and economic development functions. We are willing, but we need the tools to do the job and the flexibility to use them appropriately.

States need economic development tools to stimulate job creation, encourage business expansion and increase productivity. When virtually all federal economic development programs are slated for termination, and many have been eliminated already, industrial revenue bonds (IRBs) become almost the only tool available for financing business development in economically underdeveloped or distressed communities. In our present time of austerity, IRBs are a cheaper federal economic development program than the direct federal expenditure programs that are now being cut back, they are available to a large number of jurisdictions, they provide great local flexibility for matching funds with local economic needs, and they rely on the private market place for the lion's share of funding.

As you know, 47 States issue industrial revenue bonds. The principal beneficiaries of small issue industrial development bonds (IDBs), according to both the CBO and The Department of the Treasury, are small businesses. In fact, the primary utility of IDBs is their effectiveness in increasing investment in small businesses that provide such a large percentage of this nation's employment, entrepreneurial initiative and increased productivity.

IDBs are an essential economic development tool, particularly in our poorer States. Let me use Mississippi as an example.

Mississippi was the first State to enact legislation, in 1936, authorizing local governments to issue tax exempt bonds for industrial development projects.

The original purpose of these bonds in my State was to promote industrial development and to strengthen the manufacturing base of a very depressed, rural economy. While Mississippi has made dramatic economic progress in the last forty years, our State today remains one of the poorest in the Nation. We rank last among the fifty States in per capita income. We have the highest infant mortality rate in the Nation. Mississippi also has one of the lowest education attainment levels, and one of the highest drop-out rates, of any State. We continue to face pressing human needs and problems due to poverty, underemployment and a lack of adequate job opportunities for workers in our State. For these reasons, economic development and job creation, together with improvements in our State educational system, are the top priorities of my Administration.

IDBs have been an important economic development tool in Mississippi. Much of the progress we have made in expanding manufacturing jobs has been assisted by IDB financing. IDBs have provided the means for capital formation which has not been otherwise present. The small issue IDB financing has helped to create jobs and industry where none existed before. Without the availability of IDB financing, I am convinced that many of the new plants would not have been constructed.

Today, I come before you to discuss two proposals of the Administration: its recommended revision to the tax laws affecting tax exempt financing and IRS Revenue Ruling 81-216.

The President has recommended an eight part proposal to place restrictions on State and local non-general obligation tax exempt bonds. It is our conclusion that the net effect of these draconian measures is to eliminate the further issuance of small issue industrial development bonds and severely restrict other types of industrial revenue bonds in the out years of the budget. Ironically, using the Administration's own estimates, the proposed changes in the tax law will drain the Treasury of an additional $200 million in revenues in FY 1983 at a time when Congress is trying to identify increased sources of funds.

Congress has exempted the interest of industrial revenue bonds from federal income taxation because the bonds must be used to meet specified valid and important public purposes. Moreover, State and local governments make a second determination prior to issuance that the project will confer a public benefit. The bonds are used for such public purposes as a) the construction of hospitals, educational institutions, low income multi-family rental housing, airports and mass transportation, b) the funding of scholarships, and c) the creation of jobs and support for economic development through construction of industrial plants and businesses operated primarily by small businesses. The Administration clearly is already calling these uses into question by pejoratively declaring that these bonds provide support only for private purposes.

Let's take a look at the Administration's proposals.

First, Treasury has proposed two limitations on IRBs which appear to have such significant negative impact that, if adopted, they would probably stop further IRB issuance.

One proposal requires businesses to choose between the benefits of tax exempt financing and the tax savings from the Accelerated Cost Recovery System (ACRS). Based on preliminary analyses undertaken by the State of Missouri and my own State, only those few firms with severe capital needs and poor economic prospects would choose IRB financing over the use of ACRS. These unprofitable corporations would probably not be credit-worthy. In our estimation the effect of the forced choice would be few if any users of industrial revenue bonds. The impact on IRBs issued under IRC Section 103(b)(4) used to finance low income multi-family rental housing would be particularly severe. Congress and the Administration recently passed the Economic Recovery Tax Act giving special inducements for construction of low income multi-family rental housing in addition to ACRS. The forced choice between IRBs and ACRS would eliminate the incentives just provided.

The National Governors' Association has requested the Treasury to share with us its study that describes the financial implications of having to choose between industrial revenue bonds and the accelerated cost recovery system. To date, we have not received a copy, and therefore, we are unable to judge Treasury's justification for its proposal.

Second, another major limitation proposed by Treasury is the requirement that the governmental unit issuing IRBs must make a financial contribution or commitment to the project. While we don't know what is meant by the phrase "financial contribution or commitment", we do know that this limitation will present enormous difficulties.

A careful analysis of the impact of this proposal is needed. We have heard that as many as thirty States are barred by their State constitutions from supporting IRBs with either their "full, faith and credit" or "guarantee". Specific examples are Missouri and Colorado. We have also heard that Maryland is barred from offering tax abatements. It is our present impression that the "contribution or commitment" provision will bar many States from issuing IRBs. Expecting the States to amend their constitutions to comply with this kind of federal statutory requirement is both unrealistic and violative of our federal system of government.

Finally, this proposal appears to assume that the States are not currently making a contribution to the supported projects. CBO stated in its April 1981 study of small issue industrial revenue bonds that many States are already providing financial incentives. Most States exempt the interest of such bonds from State income tax and others also exempt IRB financed projects from property and sales taxes. Congress should have a study conducted on present State contributions before anything further in this area is required.

Third, while the rest of the Administration and Congress is trying to reduce red tape and bureaucracy and to reduce federal interference with the operation of State and local governments, the Treasury Department is suggesting the following:

a) increasing the cost of issuance by requiring registration of industrial revenue bonds;

b) increasing the cost and time of issuance by requiring public notice of a public hearing and the holding of a hearing by both the issuing governmental jurisdiction and the political jurisdiction in which the financially supported facility will be located;

c) increasing the paperwork, delaying the processing and adding to the layers of review by requiring approval of the bonds by an elected official or legislative body in addition to the approval by the existing legally constituted and empowered public agency or requiring separate approval by voter referendum for each supported facility;

d) increasing the cost by requiring public notice after the bond is approved; and

e) adding to the paper work cost by requiring reporting by the State or local government to the Internal Revenue Service (Permitting reporting by local governments directly to IRS rather than through the States will be inefficient for Treasury and will bypass State authority.).

Fourth, the Administration would restrict the yields issuers of IRBs could earn on bond proceeds during the temporary construction period and on reserve funds. Once again, the Administration does not appear to have measured the impact of its proposed modification. It is our judgment that this proposal might jeopardize the financing of the issuing agencies. But more importantly the individual projects directly supported by the bonds might be jeopardized due to the increased risk of not having sufficient reserves. Particularly in the building of low income multi-family rental housing where construction delays are endemic, the inability to earn market rate interest on funds during construction periods may make it impossible to cover increased inflationary construction costs that result from those delays. Moreover, the proposal fails to appreciate the risks involved in mortgaging and operating low income multi-family rental housing. Sufficient reserves, consisting of the original set-aside and earned interest, are needed to withstand the non-payment of rents and damage to property that frequently occur.

Fifth, the Treasury would further restrict small issue IDBs to small businesses. The Administration has not yet demonstrated the need for a limitation of this kind since both the CBO study, already referenced, and

Treasury recognize 84% of the dollar volume of IDBs in 1978 and 1979 went to non Fortune 1000 industrial companies and non Fortune 50 nonindustrial companies, and 93% of the number of small issue IDBs went to medium and small companies. Further, there is no demonstration: a) why a capital expenditure limitation is the proper criterion for a small business limitation, b) whether the capital expenditure data for making this judgment is available, or c) why the $20 million figure is appropriate.

The Administration's suggested revisions especially target small issue industrial development bonds. According to the Public Securities Association, however, only seven percent of long-term municipal bonds in 1981 were for industrial aid of which small issue industrial development bonds were an even smaller portion. The single minded focus on small issue IDBs is myopic economic policy.

The Administration's proposal to modify the corporate minimum tax by expanding to the items of tax preference, tax deductions for debt to buy or carry tax-exempt securites concerns us. We are certain that the proposed tax will have a major negative effect on the spread between tax exempt and corporate bonds. If the minimum tax were to be extended also to the tax exempt interest of municipal bonds held by either corporations or individuals, the results in the costs to State and local governments for all municipal bonds - both general obligation and industrial revenue - would be so much the worse. Banks hold almost 45% of the $328 billion of outstanding municipal bonds and are prime candidates for the minimum corporate tax. It is our understanding that the demand for municipal bonds by banks will decline by 20-30% as a result of the Administration's minimum corporate tax proposal. In addition, we understand that the bond market is already showing some resistance to municipals as a result of the Administration's proposed minimum tax proposal through the reduction of the current spread.

NGA suggests that you oppose the Administration's proposal to restrict tax exempt bonds until you have had sufficient time to hold separate hearings on the Administration's proposals and have had the opportunity to consider other responsible reforms. NGA is concerned that the issue of IRBs will be lost in the issues of the larger revenue package which is currently under consideration. Further, we feel that we all should have a much better idea of what the likely impact of modifications will be before those changes are adopted. NGA would be glad to cooperate with the Committee seeking improvements in the way IRBs are used.

We hope that you view the minimum corporate tax proposal as a significant opportunity to make State and local tax exempt bonds much more desirable by exempting them from the preference items required to be returned to the taxable income base. Such action would enhance the attractiveness of tax exempt bonds relative to other tax shelters, and probably reduce the cost of such financing by State and local governments. This action might restore municipal bonds to their historic price relationship to corporate bonds.

The reduction by Congress of the individual and capital gains tax rates, the creation of the All Savers Certificates, and the creation of other tax shelters in the last year and a half have all contributed to the relative decline in attractiveness and increased cost to States and localities of municipals. Now there is an opportunity for Congress to reverse the impact of its earlier actions.

Finally, NGA respectfully requests that you take immediate action to reverse the effect of IRS Revenue Ruling 81-216 and its successor proposed regulation. Since August 24, 1981 pooled small issue industrial development bonds have been dead in the water. Programs in 50 States and Puerto Rico are adversely affected. Twenty-two States will lose valuable programs of assistance to small businesses, and 17 will lose their agricultural development programs.

Pooling of small issues is necessary. We need access to economies of scale in marketing. We need to be able to have issues guaranteed so that unrated firms can be assisted. We need to be able to deal positively with purchasers' needs for risk diversification in their portfolios. Revenue Ruling 81-216 precludes us from doing these things and as a result closes the door on many small businesses.

I appreciate the opportunity to testify on these important issues. I believe you will find NGA and the States responsive to your desire to arrive at mutually satisfactory solutions to make our partnership work better.

The **Chairman**. Senator Stennis, do you want to add anything to those comments? I would say we have had a number of witnesses yesterday on this issue, and we believe we can make some adjustments. We hope they are within your definition of reasonable.

We also, again, find that most of the benefits go to a few large companies, and we are trying to prevent that.

Senator **Stennis**. Well, Mr. Chairman, I want to thank you for the encouraging statement you made. I remember when this program originated. It was greatly criticized at the time. It was led by a very fine businessman, a Governor that we had. He busted everything in front of him and put it over anyway. And it has become of tremendous value in many other States, particularly in the times that we are faced with now. And with proper curbs I can testify that I know what it can do and will do. And I hope you see fit to save this program.

The **Chairman**. Senator Stennis, are you coming back this afternoon to make a statement?

Senator **Stennis**. I will be back briefly on another matter, Mr. Chairman. Thank you very much.

The **Chairman**. Thank you.

Thank you very much, Governor.

Governor **Winter**. Mr. Chairman, I would like to leave one other document with you. This is a study that has been done in our State with respect to the effect of the accelerated cost recovery system on a specific industry in terms of the effect on the options that that industry would have, with respect to the accelerated cost recovery and industrial development financing. I think that would be helpful to you.

The **Chairman**. Thank you. We will make that a part of the record, Governor.

[The document follows:]

Exhibit I

MEMORANDUM RE COST RECOVERY SYSTEMS AND TAX-EXEMPT FINANCING

A. PROPOSAL BACKGROUND

A U. S. Treasury Department proposal presently under consideration envisions requiring businesses to elect between the incentives offered through use of (1) tax-exempt Industrial Development Bond (IDB) financing or (2) the new Accelerated Cost Recovery System (ACRS) and the Investment Tax Credit (ITC). A business seeking to establish or expand its plant and equipment would have a choice of using tax-exempt IDB financing in which case it would have to forego use of ACRS and new ITC benefits as modified by the Economic Recovery Tax Act of 1981 (ERTA) or using ACRS and ITC benefits in which case it would have to forego use of tax-exempt IDB financing. This memorandum addresses the potential impact of such a proposal.

If such a proposal should become law, business would suffer a substantial set back. At present businesses have available to them use of ACRS and the new ITC within the framework of the Internal Revenue Code of 1954 (the "Code"), as most recently amended by ERTA. To require businesses to forego use of cost recovery systems (depreciation of plant and equipment) and ITC provisions to become eligible for tax-exempt IDB financing would take away a major incentive to establish and/or expand one's investment in plant, machinery and equipment.

B. ASSUMPTIONS

As a basis for analysis of the impact of implementation of such a proposal, the following assumptions are made:

1. The following industrial facility consisting of land, buildings, machinery and equipment is first placed in service January 1, 1982:

Fixed Assets	Cost	Useful Life	ACRS Class
Land	$ 1,000,000	N/A	N/A
Buildings	5,000,000	40 Years	15 Years
Machinery & Equipment	4,000,000	12 Years	5 Years
	$10,000,000		

2. The industrial facility is financed by a bond issue in the amount of $10,000,000 with no issuing costs, e.g. underwriting, printing, legal and accounting. The bonds have a Moody's A credit rating.

3. Interest rates are 14.5% tax-exempt and 17.5% taxable.

4. All principal on the bonds is to be paid as a single balloon or bullet payment in the twentieth (20th) year.

5. The Company has a corporate marginal tax rate for federal income tax purposes of 46%.

6. State and local taxes, if any, have not been considered.

7. The Company has sufficient income to use the deductions and tax credits created.

C. SCHEDULES

1. BUILDINGS

	Cost Recovery	
(Year)	ACRS	Straight Line Depreciation With Zero Salvage Value
1	$ 600,000	$ 125,000
2	500,000	125,000
3	450,000	125,000
4	400,000	125,000
5	350,000	125,000
6	300,000	125,000
7	300,000	125,000
8	300,000	125,000
9	300,000	125,000
10	250,000	125,000
11	250,000	125,000
12	250,000	125,000
13	250,000	125,000
14	250,000	125,000
15	250,000	125,000
16	-	125,000
17	-	125,000
18	-	125,000
19	-	125,000
20	-	125,000
21	-	125,000
22	-	125,000
23	-	125,000
24	-	125,000
25	-	125,000
26	-	125,000
27	-	125,000
28	-	125,000
29	-	125,000
30	-	125,000
31	-	125,000
32	-	125,000
33	-	125,000
34	-	125,000
35	-	125,000
36	-	125,000
37	-	125,000
38	-	125,000
39	-	125,000
40	-	125,000
	$5,000,000	$5,000,000

2. MACHINERY AND EQUIPMENT

Cost Recovery

(Year)	ACRS 5 Year Property ($4,000,000)	Straight Line Depreciation With Zero Salvage Value 12 Year Property ($4,000,000)
1	$ 600,000	$ 333,333
2	880,000	333,333
3	840,000	333,333
4	840,000	333,333
5	840,000	333,333
6	-	333,333
7	-	333,333
8	-	333,333
9	-	333,333
10	-	333,333
11	-	333,333
12	-	333,333
	$4,000,000	$4,000,000

ITC

ERTA	(Year)		PRIOR LAW	(Year)	
5 Year Property	1	$400,000	*12 Year Property	1	$400,000

*Assuming no limitations under §46(a)(3) of the Code.

3. INTEREST

For each year the Bonds remain outstanding, additional interest expense in the amount of $300,000 will be incurred if the interest on the Bonds is subject to taxation.

D. ANALYSIS

Year 1

	ACRS (and no tax-exempt financing)	vs.	Depreciation (with tax-exempt financing)
Building write-off	$ 600,000		$125,000
Equipment write-off	600,000		333,000
	1,200,000		458,000
Excess interest expense	300,000		0
Tax Rate	46%		46%
	690,000		210,680
ITC	400,000		400,000
Tax Savings	$1,090,000		$610,680
Less: Payment of Excess Interest	(300,000)		(0)
Positive Cash Flow	$ 790,000		$610,680

Year 2

	ACRS (and no tax-exempt financing)	vs.	Depreciation (with tax-exempt financing)
Building write-off	$ 500,000		$125,000
Equipment write-off	880,000		333,000
	1,380,000		458,000
Excess interest expense	300,000		0
	1,680,000		458,000
Tax Rate	46%		46%
	772,800		210,680
ITC	0		0
Tax Savings	$ 772,800		$210,680
Less: Payment of Excess Interest	(300,000)		(0)
Positive Cash Flow	$ 472,800		$210,680

Year 3

	ACRS (and no tax-exempt financing)	vs.	Depreciation (with tax-exempt financing)
Building write-off	$ 450,000		$125,000
Equipment write-off	840,000		333,000
	1,290,000		458,000
Excess interest expense	300,000		0
	1,590,000		458,000
Tax Rate	46%		46%
	731,400		210,680
ITC	0		0
Tax Savings	$ 731,400		$210,680
Less: Payment of Excess Interest	(300,000)		(0)
Positive Cash Flow	$ 431,400		$210,680

Two questions must be asked. First, what tax deductions and credits are available to the Company? Second, what affect is had upon the cash flow of the Company? The preceding analysis illustrates that the Treasury's proposal to allow for an election to utilize ACRS without the use of tax exempt financing or to forego ACRS to obtain tax-exempt financing would discourage investment in plant, machinery and equipment because advantages currently available would be reduced. Such a proposal effectively would abolish tax exempt financing. Although the more favorable positive cash flow trend established by utilization of ACRS without the use of tax-exempt financing would become less favorable in later years, the great disparity in the initial years combined with the time value of money in an inflationary economy would eliminate any true choice in the election.

Senator STENNIS. Mr. Chairman, I should have said that Governor Winter is vice chairman of the National Governors' Association, of which Governor Snelling of Vermont is chairman.

The CHAIRMAN. He is doing a good job.

Governor WINTER. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you.

Thank you, Senator Stennis.

Now we will go back to leasing.

Senator Symms.

Senator SYMMS. Well, thank you very much, Governor. We appreciate having you here.

Mr. Chairman, I apologize that I wasn't here when the panel testified, and I apologize to those of you on the panel because I am very interested in the subject and it is getting a great deal of attention. But we have another problem, which I know some of you are interested in up in the Public Works Committee called the Clean Air Act, and I was required to be there.

If I understand correctly from scanning through your testimony, what your basic thrust is is that the leasing is making ACRS available for everyone. So I guess, Mr. Chairman, I would just make an observation that if the problem that this committee has with leasing is that it is overdoing the tax cut, well then it looks to me like if we thought we passed a bill last summer that was appropriate that then we should look back at the rates on ACRS and not try to tamper with leasing unless we are willing to start getting prepared for bailouts or some other form.

I happened to have been one of those on the committee that favored the loss carryback and forward. But, in retrospect, I wonder if that wouldn't just bring about more takeovers. Would any of you want to comment on that?

Mr. BORMAN. I think that is correct. There is clearly, as Mr. Seidman pointed out, the advantage of having an oil company buy you. It is enormously appealing at this time. Perhaps you could comment on that basis. But that is one of the options that I have, that Eastern is to look for someone to acquire the company so that we can continue in business.

Senator SYMMS. To take it over so they can take advantage of the tax losses?

Mr. BORMAN. Yes, sir.

Mr. SEIDMAN. Fundamentally, that is true in the mining business, unfortunately I think, to some extent. A lot of that has already happened. But those of us who are independent clearly are at the kind of an economic disadvantage that makes it unfair to our shareholders to try to operate on that basis. So, in the long run, either voluntarily or involuntarily, I think you will see the kinds of merger-bailouts coming along in these industries that are represented here today.

Mr. DICKEY. I can add to that.

I am not sure I would like our company categorized as a "distressed company," because I don't feel we are. We are certainly not losing money; we are making money. And we have a cashflow.

But, as I pointed out in my earlier testimony, we have capital programs which are necessitated to modernize our plants which are so big that our earnings are simply not large enough to take advantage of the provisions in the accelerated cost recovery system.

But if it was not for safe harbor leasing, in 5 years we would have an accumulation of $250 million of unused tax benefits and, therefore, obviously, that would be something that could be quite attractive to a company, a predator, who was interested only in that and in buying Scott Paper Co. for that purpose.

Senator **Symms**. I might make one other suggestion to those of you who are in this plight. I happen to be one of them here on the committee that—I am not in favor of opening up the tax bill at all. I want to approach this problem that the economy is in from the spending side of the equation. But there may be some give and take.

But I think one of the problems that you face politically is that the public—and I don't think they are ever going to get that picture out of the national establishment news media that the corporations, even when you make a profit you really don't pay the taxes anyway, you just collect them from the people who buy your products and send it on to the Government, and that ultimately it ends up in either the price of the steel or the airline ticket or the copper, or whatever happens. I mean that those profits are really just collected by business and sent on to Government, but people are paying all those taxes anyway.

I think you ought to make some commercials and point this out so that when these articles hit the press, where some company sells or buys $2.6 billion worth of tax losses, the taxpaying citizen out there gets the picture that, if we really want to get the economy going, if we want to see growth and jobs in the private sector, to go out here and raise taxes on the corporations that are already in a short cashflow position is going to do little good to help the economy. And who's kidding who? People pay taxes, business collects taxes, but you also provide jobs.

That's why I take the position I do. I think it would be a real mistake to touch this leasing provision right now, in the situation in the economy that we are in.

I appreciate your coming down here and talking, and I would urge you to get your public relations people working to spread the word through every conduit that you can reach. Because you aren't going to get any help from the news media out of this. I hope you all realize that. They simply aren't going to help you.

Even some of the newspapers that may be making a big profit in buying some of these leases, they are not going to talk about that. That's something that has always escaped my imagination, but I've noticed that over the time. When they talk about obscene profits, some of them are making more profits than some of the people that they talk about. But they still continue to harp on that populist lack of economic understanding. Those things affect Congress, because we all run for office. If the public out there perceives, as Senator Bentsen pointed out, that somehow there is an inequity in the system, it is not healthy.

Thank you.

The **Chairman**. Thank you, Senator Symms.

Senator Matsunaga.

Senator **Matsunaga**. Thank you, Mr. Chairman. And I wish to apologize. I had fully intended to be in time to listen to your testimony. But I have read through your testimony, Mr. Borman, and I am very impressed with the urgency of your industry, particularly, in need of this safe harbor leasing.

As you know, in Hawaii we are so dependent upon a healthy airline industry. Without a healthy industry which brings tourists into Hawaii, of course our economy which is mostly dependent upon tourism would be in need of welfare from the Federal Government, definitely.

In going through your testimony, you point out that the airlines are in a very bleak economic situation. I don't know whether this has been pointed out, but it is my understanding that, of the 12 major carriers, 6 reported losses in 1981 and the remaining 6 carriers, although not in the red, are not doing very well either.

When you aggregate all of the 12 major air carriers, it is my understanding that there was a net loss of a half a billion dollars. Am I correct here?

Mr. **Borman**. Yes, sir, I believe in 1981 it was more like a loss of $780 million for the top 12 carriers.

Senator **Matsunaga**. It is my understanding also that the 17 national carriers and the remaining regional carriers are in as bad a position as the major carriers. Am I correct?

Mr. **Borman**. I think that the national carriers have done better adjusting to deregulation than the majors have. We have been subjected to vigorous new competition—the majors have—and I think that the national carriers have done better since 1978, and several of them are profitable.

On the other hand, I think that this is a transitory period as we adjust to the free market.

Senator **Matsunaga**. Given the situation as it is, the incresed tax incentives under the 1981 Tax Act would be useless for most air carriers without the safe harbor leasing provision. Am I correct?

Mr. **Borman**. Yes, sir.

Senator **Matsunaga**. From your testimony, because of the safe harbor leasing provisions, you had altered your plans as to restructuring, et cetera. That if the popular notion that the safe lease harbor provision is a boondoggle carries through the minds of the majority of us Members of Congress, then the airline industry would find itself in a very distressed situation.

Mr. **Borman**. That is correct, sir.

Senator **Matsunaga**. I would think, and I agree with Senator Symms, that perhaps you who are mostly affected by a repeal of this provision might look into letting the public know and letting Members of Congress know through the constituents the grave effect of repeal.

I think that perhaps a provision, not repealing but modifying it to the point of at least giving the relief intended to those distressed industries, might accomplish the purpose which was intended by Congress and relieve Congress of even graver consequences if the provision were totally repealed. Do you agree with that?

Mr. **Borman**. I agree with that, and we will do as you suggested.

Senator **Matsunaga**. I see my time is up.

The **Chairman**. If you have another question, go ahead. My time is about up, that is the only problem.

Senator **Matsunaga**. Well, how do you feel about confining the provision to distressed industries? What would your suggestions be as to what the definition of the term "distressed" should be?

Mr. **Borman**. Well, sir, I testified earlier that I think if you are going to modify the bill perhaps it would be best to place some limitation on the buyer's ability to offset taxes by the amount of tax leasing they do.

The distressed industries—obviously all of us at this table would feel very strongly that our industries are distressed, and the numbers speak for themselves.

I think it would be difficult to categorize the total industrial scene. You could accomplish the same by limiting the amount of purchase. Maybe somebody else would like to comment on that.

Mr. **Seidman**. I would agree with that. I think that the provisions themselves are practically designed so that the distressed industries use them.

To the extent that there have been some abuses from industries that are not in that category, I think that those might be taken care of by more technical amendments so that particular kinds of deductions aren't used to gain advantage when that was not intended.

Senator **Matsunaga**. As you know, the Congress is very much concerned about the rising unemployment rate. What would your estimate be if this provision were totally repealed, as to the effect on the employment within your industry?

Mr. **Borman**. Well, sir, the airline industry already has over 35,000 people on layoff. Lockheed has quit building the 1011 airplane; Douglas has very difficult problems from the standpoint of commercial billing; and I think this would severely impact Boeing.

I honestly believe it would effectively dry up the market for new airplanes. Without the new airplanes the airline industry and the commercial aerospace industry has very difficult problems.

Senator **Matsunaga**. You don't happen to know how many employees would be involved?

Mr. **Borman**. I don't have the exact number. There are estimates of how many man-years are lost with every $1 million of investment, and I believe it is something like 26,000 man-years per million dollars of investment. So there is an enormous amount of jobs at stake here.

In the final analysis I think that is what we are all concerned about, is investment to provide jobs. So there is an awful lot at stake.

Senator **Matsunaga**. For the record, could you give us some figures at a later date?

Mr. **Borman**. I shall.

[The information follows:]

The **Chairman**. Thank you.

We may have some figures on employment. I think the Air Transport Association released some figures that appeared prominently in the Wichita, Kans. Eagle indicating that many of my constituents would lose their jobs if I continued to pursue this effort to modify or repeal this provision. Which I appreciated very much. [Laughter.]

Mr. **Borman**. I was not responsible for that, Mr. Chairman.

The **Chairman**. Well, it wasn't an ad; it was a news story. [Laughter.]

Senator **Symms**. Mr. Chairman, I take back all of those things I said about the news media. [Laughter.]

The **Chairman**. Don't take them all back, because I don't know what's going to happen yet.

Well, as you can see, your No. 1 problem, I believe, is perception. I think you have a lot of work to do if this is not going to be repealed outright.

There is a question on whether or not these are efficient. What do you say, 95 percent? We are going to dispute that at the appropriate time.

Mr. **Penick**. Mr. Chairman, I would make this suggestion. We did our survey based on a sample—we didn't have anywhere near the base of data that certainly the Joint Committee staff allowed or the Treasury has. I think it would be very useful from our viewpoint, perhaps yours as well, for us to sit down with the staff people, and let's compare assumptions, and let's not go down different paths.

The **Chairman**. Right, because I think they do have all the data that has been furnished. They get a much smaller percentage. What did you have, about 95 percent?

Mr. **Penick**. Well, it depends on the term of the lease. Our calculations indicate that for the sample that was made, for those who were on their 5-year lease terms, they were receiving about 95 percent of the maximum benefits they could hope to receive if they had been able to use the ACRS.

The **Chairman**. Plus, I think the question is whether or not this is a subsidy to unprofitable firms, as it may be, and whether in many cases the leasing gives these firms that are losing money a stronger incentive to invest; which is a sort of strange industrial policy—if you are losing money but you can make money off the tax system, you invest only for that reason, which may or may not be good management or good policy. So I think that's an area that needs to be addressed.

Senator Boren has touched on the diversion of investment. I think the Amoco example is one that certainly is questionable. Whether or not there is neutrality, I guess we have mixed views on that.

I would say, in response to Senator Bentsen's question, I don't believe that Treasury has revised their cost estimates. They still think they are pretty much on target—$1 billion last year, as I recall; $2.9 billion in 1983; $4.6 billion in 1984; and $6.5 billion in 1985. They are still sticking with those estimates. We asked them again to reestimate after our December hearings last year, and we are told that they still stick with these figures. So that would make the total cost substantial but not a massive increase in the cost of the program.

No doubt the leasing provisions—and we can always equate it with something else. I chair the food stamp committee, for example, but I am not so certain that would be a fair comparison. I mean we are talking about two different things, totally.

But there is that perception. You have made Herblock and Buchwald's column. Others have ridiculed the program, too. Frankly, I think there is some justification; although they probably don't understand it, either. But that's not a requirement around here that I know of, that you understand the program, whether you are in the Congress or out. But let's see if I can find the unemployment figures.

[Pause.]

The CHAIRMAN. It says, "The Washington-based trade group charged Monday" that I moved "to jeopardize the orders for 233 jetliners"—I didn't realize we had done that much—"valued at $7 billion."

Let's see, it does talk about the Seattle work force being lowered, but it doesn't give the total estimates.

Mr. PENICK. Of jobs, do you mean, sir?

The CHAIRMAN. Right. Jobs.

I don't have any quarrel with anybody being upset, but I think we have an obligation. I remember saying last year on the Senate floor that if in fact we found a provision—I think Senator Exon asked me the question—if we found provisions that we felt should be reviewed, were we willing to do that? I think that's an obligation we have. If we just sit here and do nothing and say, "Oh, now don't worry about this. It's only something that people don't understand," I don't think that would be very responsible management on our part.

So we are doing what I think we should do. And the date of February 19 was chosen to give people notice that we were going to do something. It may or may not be the final date. But I don't want to leave any hope that, as far as I am concerned, we are going to switch to refundability. There is no way to monitor that at all. You can't even prove there is any investment; all you have is the audit lottery, and they are getting less and less likely because of the cuts in the IRS budget.

So if you are talking about something that can't be abused, we discussed this at some length last summer. It wasn't that we didn't discuss all the options: We discussed assignability, refundability, and this procedure was devised because the lessor had at least a marginal interest in whether or not an investment was made. That's the basis for this program.

I might say, not that we are not accessible, but it would appear to me that I shouldn't be meeting with people who had a direct interest in this until we have had testimony. I might say I was trapped into a meeting in Senator Baker's office the other day that I didn't appreciate at all, but I didn't arrange the meeting. I know many here have been trying to get in to see us. It is not that we are hostile; we just don't believe that until the Joint Committee and our committee finishes its work that we ought to be discussing options with anybody who has an interest.

Does anybody else on the panel have any comments? We don't want to foreclose anyone.

[No response.]

The CHAIRMAN. But you do understand we have a problem, or that you have a problem?

Mr. BORMAN. Yes, sir. And I understand the problem of perception. On the other hand, I think we look to you to have, and I know you do have, the interest of what is right in mind, regardless of the perception.

I believe, in the final analysis, that this program does provide jobs and does provide the incentive that is going to get us going.

And I understand the concern about the lady in Oklahoma. On the other hand, I would submit to you that the program here is going to provide thousands and thousands of jobs.

You know, just one other thing. We made a conscious decision based upon the Congress action in August. And now, not 5 months later, a $900 million investment decision is in severe jeopardy because it is being reviewed. And it is a problem to us—an enormous problem.

The CHAIRMAN. Wouldn't you exercise the same review right as chairman of the board of Eastern, if somebody raised questions about some of your operations? Don't you review your policies from time to time?

Mr. BORMAN. Yes, sir. But when you commit the corporation to a $900 million investment decision, that is like getting a large freight train going down the track. And it is very, very difficult to change it.

I understand your perception problem. But if the program is indeed good for the country, and we will try to help educate the people, I expect the perception problem to be one that we can overcome. If you don't think it is good for the country, then it's a different story.

The CHAIRMAN. I think, very honestly, my own view is that, had the recession not come along, you would never have heard much about the leasing provision or anything else. When you start looking at big, big deficits—you have a $600 million problem and, as I said, we have a $150-some billion problem—and suddenly there is focus on everything. We have gone through every tax expenditure, a $285 billion review of tax expenditures, trying to figure out how we can find a few hundred million dollars or billion dollars in different areas. This is obviously one provision that was raised by a number of Senators as early as last December.

Let's say in the committee that someone offered to cut medicaid $1 billion, and somebody offered as a substitute to cut leasing $1 billion. Now, can you tell me which would win? It would be pretty easy to say what would be the outcome. I mean that is not necessarily the way it should work, but it could work that way.

I don't want to be contentious about it, but we have a problem. You've got the problem if we change the law, and we've got the problem if we don't change the law. So maybe we can figure out something.

Senator Boren?

Senator BOREN. Mr. Chairman, I don't want to belabor the point, but I think there is more than a perception problem. I think if some of us are interpreted as indicating that it is only a perception problem, I think they're wrong.

Again, not to be contentious, I must admit the statement that, well, this is all working fine really set me off, because I just can't imagine anyone making that statement.

It seems to me, instead of wasting time—and I would have to differ with my good friend Senator Symms on this—I don't think you ought to be launching a public relations effort to say, "This is all just working like it should. Everything is just peachy-keen." I would urge you to use your time and energy and expertise devising improvements on this method.

I am not hostile to the idea that there should be capital formation for industries like yours. I am not hostile to the idea that there should be a level playing field. I agree with all of those things you said. But I think it should cause you to pause when you look at the fact you have heard this morning from Senator Hatch about it; we've heard from Senator Dole, you've heard from Senator Bentsen, we've heard previously from Senator Harry Byrd, myself—a group of very dangerous radicals who probably have a composite chamber of commerce average in excess of 90 percent.

The **CHAIRMAN**. 101 percent.

Senator **BOREN**. Maybe 100 percent, I don't know. Close to it. Even the president of the U.S. Chamber, and I quote him, says, "I think it's a lousy piece of legislation. The safe harbor leasing rules in many cases subsidizes bad management; it causes an investment to be made that would not be wise on a pretax basis." Now, that's another dangerous radical, the president of the U.S. Chamber of Commerce.

All I would say is that you have the Amoco thing, where it looks like a profitable company has diverted funds from exploration and development into buying these tax credits, and you have a lot of other problems with it on that side of the coin.

That doesn't mean we aren't 100 percent sympathetic with the problems of industries that find themselves in your situation, and in many cases through no fault of those companies but through the general economic conditions.

I would urge you: Devote your time to trying to help us find ways of improving this and targeting the tax policy to help the capital formation in those industries that need to be retooled to bring them back to health again And don't spend time trying to say that it is all working like it should, because it isn't; and it makes it all the harder for those of us who are sympathetic to be for it.

I think, frankly, as one who feels strongly—I am for investment tax credits, and I am for ACRS, and I have sponsored capital cost recovery ever since I got here—it discredits the cause of all of us who are for those kinds of sound economic policies to have it portrayed that if we are for that we must also be for this kind of situation, which has gone astray in some cases. I would urge you to look at the broader picture.

Senator **SYMMS**. Mr. Chairman, I don't want to belabor the meeting, either, but I would like for my good friend from Oklahoma to not misinterpret that I am trying to encourage these people to buy commercials on the Tax Code. I am talking about the general principle.

A tax increase is a tax increase. And you are taking money out of the private sector and putting it in the Government sector. The real question that we face in Washington, in my opinion, is it's what we spend that matters. Whether we borrow the money or we tax for it or we print money and pay for it with funny money, it all ends up that it takes money away from the private sector, puts it in the Government sector, and the rate of growth of Government is still going up.

Now, for us to come in here and repeal part of this Tax Code that we passed last summer, I think, as Colonel Borman pointed out, is only going to cause more cynicism on the part of those people out in the private sector that the Government just can't leave a policy in place. If we just would not change the rules for a while, they will be able to play the game. What we need to do is get our spending side of this equation in order, and we will get economic recovery. And these corporations, wherever you look, you can't squeeze blood out of a turnip.

I think we are going to get a real shock if we think if we balance the budget that interest rates are going to come down, if we do that balancing of the budget by raising taxes. Because, what do they do? They have to go borrow the money to pay the taxes or they go broke, and you have more people unemployed.

That's my position. The only tax increase that I am in favor of would be one that would dedicate some more money to the Federal transportation highway system. And there might be a little benefit to balancing the budget on that, just in the time that it takes from getting it in until they spend it.

But it certainly is not going to be helpful, in my opinion, to go out here to the private sector and try to raise taxes by $50 billion in order to balance the budget. We might as well adjourn the Congress and pass a continuing resolution and go home and let the economy work its way out of it before we do that, and we would probably all be better off.

But I think if we could correct the spending side of this thing, this part will work its way out. Then, what they need to do is to help explain to the radio stations, to the newspapers in their hometowns and all across where they have plants and equipment, what can be brought about by a real growth in the economy and capital accumulation, like you are talking about, and the principle of it and the virtue of it, and the humanitarian aspect of capitalism, if you will, and not allow people to be deluded to think that corporations ever have paid taxes. I mean they collect them and pass them on to the Government.

I think it would be very detrimental to the American business community, hence, the American workingman, to go in and tamper with ACRS right now and the leasing, whatever.

The CHAIRMAN. Let me conclude by suggesting that I don't advocate opening up the Economic Recovery Tax Act either, but I do think our responsibility requires us to address areas that on second thought we believe have possible defects. That's what we are in the process of doing. Raising taxes, as Senator Symms indicates, is not good policy but closing areas that should be addressed might be good policy. That's what we are looking at on the tax expenditure side, not necessarily only this provision.

But we will be working with this group and others as we try to put together a proposal. As I said, there are 43 different options right now on this proposal. Some you might like, and some you might not like.

I think you indicate that there is at least a lot of effort being made to see if we can salvage the good features of the program. That's what we hope we can do.

We appreciate very much your testimony. Your entire statements will be made a part of the record.

Do we have a copy of the study available?

Mr. **Penick**. Yes, sir.

Senator **Symms**. Well, Mr. Chairman, I don't want to leave this committee without saying that I appreciate your interest in looking at this matter. And I do think it is proper for you to do it; don't get me wrong. I don't mind having the hearings, it's just the markup I don't want to have.

The **Chairman**. Well, just leave me your proxy, and we will take care of that. [Laughter.]

[Whereupon, at 12:23 p.m., the hearing was concluded.]

ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

THURSDAY, MARCH 18, 1982

U.S. SENATE,
SENATE FINANCE COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 2:25 p.m., in room 2221, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Heinz, Symms, and Bentsen.

Senator SYMMS. The Finance Committee will continue our hearings.

We are delighted to have my former colleague from over in the other body, Congressman Don Bailey from Pennsylvania, with us.

We look forward to hearing from you, Congressman. You go right ahead, and your entire statement will be put into our record. You may either give it or summarize it, whichever you choose.

STATEMENT OF HON. DON BAILEY, CONGRESSMAN FROM THE STATE OF PENNSYLVANIA, MEMBER, COMMITTEE ON WAYS AND MEANS

Congressman BAILEY. Senator, what I would like to do is share some reflections with you. I don't have a prepared statement. I have looked over some of the statements which will follow, and I suppose the best thing that I can do is simply expound on some of the points that I think they make very well.

Basically I am here simply, very humbly, to ask your help in resisting in whatever way you can the recommendations that the administration is making for the alternative minimum tax. It is essentially counterproductive, I think, for a multitude of reasons.

Incidentally, as I think you know, I had served on the Armed Services Committee for a term before going to the Ways and Means Committee. While there, I had the opportunity to serve on the especially impanelled subcommittee put together by the chairman on the Nation's defense industrial base. Part of the work that we did was on capital formation, and during that time it became obvious that the Nation has a number of severe problems, but essentially, if you look at aging plant and equipment, we have got a severe reinvestment problem. The inability of the country to compete, or at least compete in future years, is going to become more and more marked over the years as we move forward.

As a result of that work, I began looking at possibilities of doing something with the Tax Code to try and remedy the situation. I ended up submitting what eventually became the amendment that the Ways and Means Committee put in its proposal, that we think or like to think, at least, provided some of the pressure for insuring that in the conference committee we came out with so-called safe harbor leasing provisions. I realize that is another matter that I would like to touch on later. Of course, we ended up passing ERTA, one of the primary goals and objectives of which was to increase investment—to spur investment in the country.

Unfortunately, we have a number of especially capital-intensive industries which are particularly sensitive to cyclic undulations in the Nation's economic well-being and our economic gross national product that reflect severely on marginally profitable firms—not just industries, but on firms.

The minimum corporate tax does nothing to alleviate that problem. It's like saying to these industries on one hand, "We are going to provide you with an incentive to reinvest certain tax incentives," then taking them away on the other hand. Because, apparently, what we are really doing is responding to the political, and I think very much a political, myth about minimum corporate tax and what it means.

Secretary Regan testified before the Ways and Means Committee, and as I told him I represent a very high labor district, I have an excellent labor voting record, I am very supportive of unionism, its general goals and objectives, and I have no difficulty standing on a streetcorner in my district and saying that I don't mind if a corporation doesn't pay taxes, provided it is properly making through deductions and investment tax credits, the kind of investment that the country needs to improve its productivity.

It is illogical, it's counterproductive, and in an intellectual sense at least, it is hypocritical to impose this alternative minimum corporate tax. Incidentally, I am a prime cosponsor of a bill to repeal the existing minimum corporate tax, and very proudly a prime cosponsor of that bill with Barber Conable on the Ways and Means Committee.

We have a steel industry that has committed better than $6½ billion to modernization. The impact of the alternative minimum corporate tax, that they are talking about will probably destroy the cashflow that these firms badly need for investment purposes, to the tune of probably, among the major steel producers at least in this country, better than half a billion dollars. Now, that half a billion dollars or so is going to out there and buy, at $60 to $100 million a company, a lot of continuous casters. And that means a great deal to this country. The impact on mining is just as severe, perhaps worse.

I would strongly suggest that if we have to raise revenues, and in the budget equation and deficit problems we have, I understand the macroeconomic problems involved, one of the most counterproductive, ineffective and dangerous long-term ways to do it is via this proposal from the administration.

Let me touch very briefly on cashflow, because you may have testimony before the committee suggesting that for some reason these firms can go out and borrow sufficiently to do the kind of investment they need.

First of all, that just creates all the more pressure on the Nation's credit pool.

Second, I will be very honest with you, I introduced a bill much more up front, a transferability-refundability mechanism. What came out of the Ways and Means Committee was an extended carryback that would have provided an opportunity to especially marginally profitable firms concentrated largely in five or six targeted industries an opportunity to use their investment tax credits.

Obviously, we didn't succeed. But we did come out of the conference committee with the so-called safe harbor leasing provisions. Now, I understand that, politically, at least, there is a great deal of opposition to them. I don't share that feeling. Essentially, leasing is a transferability mechanism, doing essentially what it was they were designed to do, and that is to provide a mechanism for utilization of deductions and tax credits to avoid what everyone had feared at that time, and that was simply negative or zero corporate income. That's what everybody was afraid of. That was the political bugaboo.

So, we came up with safe harbor leasing, not to discourage the reinvestment that marginally profitable firms needed to make.

Senator, it was a good solid concept and idea. I am sure that we can clean it up. I am sure that your expertise on it is sufficient to deal with the problem of complaints about third parties who many feel, perhaps, can engender excessive discount rates, thereby taking the money from the industry which has earned the deduction in the first place. Those criticisms can be mollified and we can be left with a structure sufficient to provide the necesary mechanism. If not that, then go directly to some transferability or refundability mechanism, which is fine with me.

I wish very much that some of your colleagues were here, because I have studied very closely their opinions. I respect them very much, I know the chairman is a very able and capable man. I know Senator Durenberger has some strong views; in fact, I introduced his measure in the House before I drafted my own, which I thought to be a little more politically effective, at least, with revenue loss and that type of thing. I know the Senator from Louisiana, Senator Long, is extremely well-versed in this area. And I wouldn't attempt to challenge or compete with any of their expertise.

We as a nation have got to do something with the long-term reinvestment problem that we have in this country with capital-intensive industries generally. We are not going to find in a confrontation scenario, either economic or militarily, that we are going to be able to do without feedstock industries or capital-intensive industries. We are not going to be able to sell and deal with some type of service in an extremely high-technology economy in solving our problems worldwide.

One of the difficulties with the GATT is that the discovery techniques available to firms that wish to bring countervailing duty and antidumping cases under countries that are signatories to the GATT, in conjunction and consistent with its antisubsidy provisions, are that the provisions of law are not very effective.

We need something domestic. We need something in this Nation's Tax Code to deal with what the Europeans and what the Japanese and other steel producers are really doing to this Nation's capacity. They are dealing with excess capacity by planning it away. We have dealt with it by strangling, through economic and tax and regulatory policies, jawboning to death, our steel industry, for example, and our mining industry. We have cobalt deposits in this country that we don't develop because it is not a sufficiently predictable investment environment to attract the capital to invest in them, and instead we import 100 percent of that stuff from overseas. Need I say more about the security of that practice? It doesn't make good sense, and I think you are very well-informed in that area.

I would end with hoping that the mechanisms that we have available, our tax deduction structures, our investment tax credit structures and schedules. We have utilized the leasing provisions to provide some kind of response to a better, a healthier, and a more encouraging investment opportunity abroad that is displacing American capacity and innovation, and destroying business initiative in this country.

And I hope that in looking over what we do domestically, how we use that Tax Code, we can recognize that international environment as well as the domestic environment, and do something with it.

In short, please do everything you can on this side of the Capitol to try and defeat this alternative minimum corporate tax. It is a hypocritical response to what I thought was the good part of the administration's tax proposals. And I would look at leasing, not with a jaundiced eye, please, but with a proper appreciation. At the very least, let's modify it and keep in place the proper objectives that it has achieved.

Any questions?

Senator SYMMS. Thank you very much, Don, for an excellent statement.

What I would like to do is to direct the staff to get his statement from the reporter in writing. I personally will see that every member of this committee gets it. You have made a statement that I couldn't agree with more.

I am sorry that my colleagues aren't here. If you notice, the bells are on. We do have a vote on the floor of the Senate, and I voted early and came over so we could continue the hearing, and I'm sorry they aren't here. I think you have made an excellent statement.

I am particularly disappointed that you weren't here this morning to testify when the television cameras were here, when you make the point that coming from a high labor district you are able to make that argument to your constituents and can view it with pride, and that they accept it, because you do an excellent job of stating your case.

I happen to agree with you. I think you are right. I am happy that you are on that committee in the House, an I commend you for the work you have been doing. Certainly you are preaching to the choir when you talk to me about the minimum tax and the leasing provision.

But we will get your statement to the rest of the Senators on the committee, because I think it is a very good statement, and it is very articulate the way you put it down. Your district is where? In the coal mining area?

Congressman BAILEY. Yes, Senator. I have a lot of specialty steel and some primary steel in my area, and a number of people that work at facilities out of my area. We also have a significant research contingent among my constituency, a great deal of coal mining and a significant amount of secondary manufacturing. And I would add the automobile industry.

Sometimes I think we don't understand the almost chicken-and-egg relationship between some of our secondary manufacturing facilities and primary metals production, for example, and the impact on our industries of not only the availability and security of supply but also on some type of price mechanism or relationship between domestic supply and what would come in overseas. By that, I simply mean the availability of steel, for example, for a domestic automobile or vehicle industry without which no modern industrial nation is going to be able to survive.

Senator SYMMS. What do you anticipate the attitude in the House will be on these two issues?

Congressman BAILEY. I would say that as we begin to discuss the alternative minimum corporate tax that the reaction of the business community as a whole has been heartening.

It is crucial that we talk to our labor people so that they understand what this means in terms of American jobs, particularly to the industrial union sector and to the building trades sector. And, of course, we are trying to do that.

I think that we can deal effectively with the alternative minimum corporate tax. I would say right now that, personally, I think we can beat it.

Senator SYMMS. Within the committee?

Congressman BAILEY. Yes, sir. I'm going to stick my neck out—Danny will probably kill me. He hits me over the head now and again, anyway.

Senator SYMMS. He had better be careful, taking you on.

Congressman BAILEY. No. I think a great deal of my chairman. I think he is a fantastic leader, and he's been very fair to me. I have been working very hard on the committee, and the business community has been working very hard, and I think we can deal with the minimum corporate tax issue. I don't think we'll get repealed right now, but I think we can defeat the alternative that has been added on. That is why it's so crucial here.

Senator SYMMS. How about the leasing?

Congressman BAILEY. Well, Senator, I would say, first of all, we don't have all the information. A lot of people don't understand there is difference between figures that reflect what could currently be used up and currently being carried; ITC load, for example, as opposed to what's being leased. Let me tell you what I mean by that.

Company X is sitting out here with a load of investment tax credits perhaps that it is carrying right now that have not expired and investment tax credits that it is currently earning. It may seek, because of cashflow advantages, to utilize the leasing mechanism.

This is my feeling, now. I will leave it to your staff to do a good indepth study on this. But I feel that that has led to a significant immediate surge in terms of revenue drain right now. And I think that it would significantly drop off if inflation were not a factor, if cashflow were not that much of a factor, if high interest rates were not that much of a factor. It would be much more profitable for an industry.

Most industries will burn them up against their tax liability as they accrue it on a year-to-year basis. They will burn those ITC's up as they use them, and they will burned those deductions up as they use them.

But what happens is that the marginally profitable firm that really is doing everything that we want to do to increase productivity gets burnt by this thing. We knock them down, then we kick them. That's the minimum corporate tax.

Leasing, on the other hand, has given them a way essentially to transfer to third parties; and that's where the criticism comes in.

Now, what we don't know yet, and what's been misunderstood, is the discount rate on those investment tax credits in that transferability environment, you see. In other words, how much profit, how much advantage, is accruing to that very profitable third party? The General Electric situation is the one everybody mentions.

Well, first of all, we don't know for sure. No. 2, we have to be very careful to understand that—again I will go back to the original point I made—to that marginally profitable company it may be more advantageous to increase cashflow and make that deal today. And, therefore, arguably, you could defend leasing as is on that ground if you cannot, in the alternative, give them some form of refundability and some form of out and out direct transferability, or limiting the discount rate, perhaps.

What happens is, somebody would come in and say, "Why shouldn't GE pay taxes?" "How much of that is getting passed on to the nominal lessee, the transferer that's what you have to look at.

The revenue drain is the same in either case, whether you do something directly for that affected or marginal firm that wants to use a refundability or transfer mechanism of any type, including safe harbor leasing, or whether it is through that third party. Again, I will go back to the fiction. The fiction was we wanted to avoid any kind of a negative corporate tax. That was the entire refundability, idea. We came up with leasing because we didn't want to do refundability a much more direct and efficient mechanism, in my opnion. But we didn't want to do it, so we invented leasing.

You want to cap it out? That's great. There is going to be enough of a market out there that we can cap it out and get rid of that criticism.

The point is, you are going to achieve the same goal either way, and the same goal was to avoid a negative corporate tax or a refund. To me, it is six of one and a half dozen the other. I don't care; I want to preserve the mechanism. I want to increase cashflow; and from the standpoint of what's good for this country in my mind, at least, an increased help for those industries in this country that is going to make it strong and viable and insure that she is safe and secure.

I've got people out of work and, dammit, I've got a competitive sense of what this country can do. It's a generic problem with capital-intensive industries.

Senator SYMMS. I appreciate your testimony and your statement, as I said. And I will just say that you certainly have been a success ever since you played football for Michigan, and your military service was certainly outstanding. We are glad to have you here in Congress, and I am glad to have you as an ally. I think with invincible Democrats like you, maybe we will be able to save this country from itself.

Congressman BAILEY. Thank you.

Senator SYMMS. At the present time we have another vote on the floor, so if the next panel could come up, which consists of Mr. Lloyd Unsell and Rex Fuller, and be prepared, anyway.

I might just say that if Senator Stennis gets here, I think we will expect him to testify next.

The committee will come back in at about 3.

[Whereupon, at 2:47 p.m., the hearing was recessed.]

AFTER RECESS

Senator SYMMS. Would the committee come back to order?

Is Senator Stennis in the room? If not, I would say, Senator Bentsen, we just heard some excellent testimony from Congressman Bailey. I had said the Senators were on the floor voting. He made an extemporaneous statement, but we will get the Reporters to get copies for the other members of the committee. It was an excellent statement on leasing and the minimum corporate tax.

Senator Stennis, do you wish to make your statement now?

Senator STENNIS. Well, Mr. Chairman, whatever you say.

Senator SYMMS. Why don't you go right ahead.

Senator STENNIS. I will only take five minutes.

Senator SYMMS. If you would like to sit down at your seat and will accept my apologies, I am going to run to the floor to vote, and Senator Bentsen will represent the committee.

STATEMENT OF HON. JOHN STENNIS, U.S. SENATOR FROM THE STATE OF MISSISSIPPI

Senator STENNIS. Sure. I thank you very much, and I certainly won't spend very much of the committee's time.

I have a matter here that is familiar, I'm sure, to all the committee members. I know it's familiar to the public because a lot of time they ask me about it. And I think it goes far beyond money importance when I refer to the safe harbor leasing tax payments and buying your way out of tax liability, and so forth, within the big tax bill that was passed last year.

I have the figures here, Mr. Chairman, about the estimated liability to the Treasury about that amendment, the ones that were first made. I have the figures here in my formal statement about the different companies that have had profits after taxes of $1 billion and $2 billion, and one of them had $2.66 billion, and were able through this law to get an interpretation or get a provision out of it that goes farther than was intended, as I believe, and who have come out without having to pay any taxes.

The last thing in the paper about it was in the March 16, Washington Post, "Pre-tax earnings for General Electric: $2.66 billion in 1981," and they would take advantage of this so-called rent-a-deduction provision to such an extent that instead of paying income taxes they get a net tax refund of $90 to $100 million.

Now I am not trying to run down or blame any of those taxpayers or whomever wrote the provision within the law. I want permission, if I may, to put my formal statement in the record at this point, and make these two points about it:

Gentlemen, we all know that we are confronted with a serious situation on the second year of President Reagan's plan. We have a hard time getting started on something definite, and the changing of opinion, or the uncertainty, or the unsafe feeling about things on behalf of the people I think is in a very critical stage.

Now, I say this after having visited 77 of the 82 counties in Mississippi. I talked to virtually every county and county district officeholder and members of their staffs—deputies and others. This provision here is causing untold damage in the minds of the people, in their faith and confidence in the effort as a whole of the Congress and the President to try to right the situation in our own budget. And it is causing untold damage to us as individuals in the Congress as a whole in the minds of the people.

So for those reasons, in this uncertain time, I think that within itself is reason why we should proceed here without delay, Mr. Chairman, and rectify what was an error to begin with. This will be something tangible and definite to put things back on the track, I think.

I am not going to belabor this, and I'm not going to make some statement to get in the paper. But this condition is so serious, I believe we ought to act and act promptly. Now, I am not predicting the worst is going to happen; I want the best to happen. But people are uncertain now, and they can get loaded with despair and bother us down. And this is one thing that we can give a quick remedy to, as I see it. They would be grateful.

I thank you very much.

The CHAIRMAN. Thank you, Senator Stennis. Your entire statement will be made a part of the record.

[The prepared statement follows:]

STATEMENT
by
SENATOR JOHN STENNIS
before
U. S. SENATE COMMITTEE ON FINANCE
Thursday, March 18, 1982

Mr. Chairman and Members of the Committee, I appreciate very much the opportunity to appear before you today to express my strong opposition to the so-called "safe harbor leasing," or, as former Internal Revenue Commissioner Sheldon S. Cohen called it, the "rent-a-deduction" provision of the Economic Recovery Tax Act of 1981. I simply do not believe that, in fairness to the average taxpayer, we can allow this provision to remain in the law as it is now written.

It has been widely charged that in passing the Economic Recovery Tax Act of 1981 we were overly generous to businesses and corporations and reduced business income tax levies to such low levels that businesses do not bear their fair share of the tax burden. While I do not concur with this assessment, I do believe that the "safe harbor leasing" provision which we are now discussing was excessively generous and should be repealed or substantially modified.

As the Committee knows, the "safe harbor leasing" provision essentially permits a paper transaction that allows the transfer of tax benefits. In a typical transaction, an unprofitable company invests in new equipment and then enters into an agreement whereby a profitable business buys the equipment and leases it back to the unprofitable firm. In most cases this is a mere paper transaction. This provision, as I understand it, was designed primarily to help financially ailing companies as well as new companies which have not yet turned a profit. However, in actual practice, they are being used in such a manner as to permit the sale of such credits to prosperous companies which do not by any stretch of the imagination need any fiscal assistance by U. S. taxpayers or from the U. S. Treasury.

The record will clearly demonstrate, I believe, that not only unprofitable firms are benefiting from this provision. Extremely profitable ones, such as Occidental Petroleum, for example, have sold tax credits that they were unable to use because other tax breaks already had done away with most of their U. S. income tax liability.

In the Washington Post of Tuesday, March 16, there is a story which says that General Electric, with pre-tax earnings of $2.66 billion in 1981, was able to take advantage of the "rent-a-deduction" provision to such an extent that, instead of paying income taxes, they will get a net tax refund of $90 million to $100 million from the federal government. This story also asserts that Amoco, with a pre-tax income of $3.46 billion, was able to reduce its federal tax liability by $159 million through the "safe harbor leasing" provision. Other instances can be cited where large corporations, which were extremely profitable in 1981, were able to buy up tax breaks and thus substantially reduce their income tax liability. I do not believe that this is what was intended by the Congress when this provision was passed.

As a matter of fact, Mr. Chairman, it is extremely difficult to determine what the intent of the Congress was in adopting this leasing provision. I am informed that it was a part of the substitute bill adopted on the floor by the House of Representatives and was not considered by either the House or Senate Committees. Although it was approved in conference, it received little more than passing mention during the consideration of the conference report on the floor of the House and Senate. This is certainly not the way to pass complicated tax legislation.

This provision, Mr. Chairman, permits corporations to buy and sell federal tax credits as though they are stocks, bonds, bushels of wheat, or other commodities. I believe that the result is a clear and unjustified raid on the United States Treasury.

The original conservative estimate of the cost to the Treasury of the leasing provision was $27 billion to $29 billion in lost tax revenues during the next five years. Other estimates are that the cost could run as much as double that amount. However, even if we accept the original estimated loss of $27 billion as valid, this amount is more than double the projected deficit in the Social Security trust fund for the next five years. The same $27 billion would fully fund for the next ten years the program of Basic Educational Opportunity, or Pell, grants to needy college students at the fiscal year 1982 budget level. Illustrations of what could be accomplished with this $27 billion could, of course, be multiplied endlessly.

I am convinced that a serious mistake was made in passing this tax provision. At best it reflects extreme and unjustified generosity for business tax cuts in the new tax law. If we allow this provision to remain unchanged, the tax loss which will result will have to be made up by increased taxes on the average American, additional cuts in governmental expenditures, or by increased federal deficits. It is poor public policy to permit the selling and trading of federal tax credits in this manner when deficits in excess of $100 billion are already staring us in the face.

I believe the Congress should rectify its mistake just as quickly as possible. The longer we delay the more tax loss the Treasury suffers. I hope this Committee will act on this matter on an urgent basis. It may be that the proper approach is something other than the outright repeal of the leasing provision. Clearly, however, it should be amended and tightened to prevent its abuse by highly profitable companies and to limit leasing to firms which are truly in need of relief which the leasing provision was designed to provide. I have confidence that the Committee will recognize the difficulties and the problems involved and will act in the best interest of the American taxpayer and the country as a whole.

I thank you again for the opportunity of appearing here today and presenting this statement.

The CHAIRMAN. Senator Bentsen, did you have a question?

Senator BENTSEN. No; no questions.

The CHAIRMAN. I appreciate very much your taking time to testify, as did Senator Hatch and Senator Pell here earlier. And we've had one panel on the problem and will have another panel on it later this afternoon.

Senator STENNIS. Thank you. I appreciate very much what you are doing.

The CHAIRMAN. Our next witnesses, a panel, are Lloyd Unsell, executive vice president of the Independent Petroleum Association of America; and Mr. Rex Fuller, chairman, National Energy Policy Committee.

Your entire statements will be made a part of the record. I hope you might be able to summarize your statements; we've lost about 45 minutes with three rollcalls, and we will speed it up if we can.

Senator, do you want to introduce the witnesses?

Senator BENTSEN. Yes, I would Mr. Chairman. These are two of the most knowledgeable men I know concerning the problems of the independent producer and independent exploratory drilling.

Rex Fuller is a man who has contributed substantially to that kind of exploration, not only in Texas, but in other parts of the country. He is a true leader amongst the independents. And Mr. Unsell is one who has a great breadth of knowledge concerning independent drilling.

I am delighted to welcome both of them here.

Thank you.

The CHAIRMAN. Lloyd, are you first?

STATEMENT OF LLOYD N. UNSELL, EXECUTIVE VICE PRESIDENT, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, WASHINGTON, D.C.

Mr. UNSELL. I guess.

I am here, as you know, Senators, representing the Independent Petroleum Association of America which has about 8,000 members nationwide and 30 State and regional organizations listed on the cover of my statement. The combined membership represents essentially all of the 15,000 independent explorer producers in the domestic industry.

In the past, energy-related tax changes have caused a great deal of uncertainty that resulted in a yo-yo effect in domestic exploration and development. One example of that was the reduction in depletion in 1979 that precipitated the two largest drops in exploratory drilling in the history of the industry, in 1970 and 1971. Another was the 1976 provisions subjecting intangible drilling costs to a minimum tax. That was a major factor in limiting the increase in 1977 of exploration and development expenditures by independents to 6 percent compared with a 71-percent increase in the previous year.

Exploration and development activities are extremely sensitive to negative tax changes because they are extraordinarily capital intensive. The industry usually takes years to recover from such changes, because its operations inherently are geared to a long lead time.

After almost two decades of contraction in the domestic industry, during which we spun out about 10,000 independent producers and which led many to conclude wrongly that we were running out of oil and gas, we finally are operating in an economic climate in which the domestic industry is getting its act together.

The previous up cycle, incidentally, ended 26 long years ago, and this one is just getting started. In 1980 we had a historic record in drilling and added as much to new crude oil reserves as we produced in that year for the first time in 14 years. In 1981, we again set a drilling record with more than 80,000 wells, and there is every reason to believe that reserve additions will be even better when the numbers are in.

We have just about doubled the number of independent producers since the 1973 embargo. Employment in exploration-production of oil and natural gas has almost tripled in the same time.

The rig count has risen 140 percent just since 1975.

Independents have accounted for about 95 percent of the increased drilling since the 1973 embargo and have consistently reinvested the equivalent of 105 percent of their gross wellhead revenues.

The explosion of oil and gas related activity is helping all sectors of the country indirectly and many industries such as steel, which is building new capacity and reviving idle mills just to supply the demand for oil country tubular needs.

The domestic industry is dead set on a course to regain a position of relative energy security for America if we are not thrown for a loss by new tax roadblocks which are aimed only at closing a revenue gap but ignore the energy supply consequences.

A favorable trend is shown in the illustrations attached to my statement; however, we are looking at some warning signals that are too recent to analyze completely but which call for concern.

First, the price of new oil has dropped from about $39 a year ago to $30 at present.

Second, we have stacked more than 700 rigs or 15 percent of the total rig inventory since January 1. This reverses an uninterrupted increase in rig activity that began in 1979. And we have never had a comparable decrease in the rig count.

The last thing this industry needs now is new uncertainty on the tax policy front. We have had time to consult only superficially with industry tax experts on the matter of the pending alternative minimum tax; however, several case studies that we have looked at show that it will result in curtailment of exploration and development expenditures on the order of 35 percent. This will be a far more negative effect than wes experienced from the add-on minimum tax which Congress partially corrected in 1977. And we request an opportunity to file a more detailed analysis on the pending minimum tax proposal for the record.

[The information follows:]

MINIMUM TAX TREATMENT OF INTANGIBLE DRILLING COSTS

In general, the proposed application of a minimum tax to IDC's will greatly reduce the funds available for reinvestment in exploration and production as well as encourage abandonment (as dry holes) of many newly drilled marginal wells.

Exploration and drilling for oil and natural gas is a "current cash" business. You don't drill wildcat wells with borrowed money--you must use internally generated cash flow from current sales of oil and gas, augmented with funds from outside investors. Every dollar of income diverted to taxes reduces, by at least a dollar and usually more, expenditures for exploration and drilling.

Even development drilling (wells drilled to develop a field following initial discovery) require internally generated cash and investor funds. Only after sufficient development has taken place so that the reserves "proved up" and actual production from existing wells demonstrate ability to repay a loan can borrowed funds be used to a limited degree for further development.

Intangible drilling and development costs are the single largest element of expenditures for the exploration-producing sector of the petroleum industry. IDC accounts for 40 percent of total outlays for exploration and development excluding lease bonus payments for offshore federal lands. IDC represents 70 percent of the total cost of drilling and equipping a successful onshore well. The other 30 percent, for tangibles such as pumps and wellheads, is capitalized.

Generally, intangible drilling costs are those expenditures incurred for materials and services used in drilling oil and gas wells and preparing them for production but having no salvage value upon abandonment of the well. Costs incurred in drilling a dry hole are always charged to current expense.

Section 263(c) of the Internal Revenue Code, provides that the taxpayer has the option to deduct such costs currently. Under the option, only the holder of a "working" or an "operating" interest (i.e., the interest which is burdened with the risks and costs of developing and operating the property) may currently deduct IDC's. Moreover, the election to deduct IDC's must be made by the taxpayer for the first taxable year in which such costs are incurred and is binding for all subsequent years.

The present treatment of IDC's for income tax purposes was first made available by administrative ruling in connection with the Revenue Act of 1916. T.D. 2447, issued February 8, 1917, reads as follows:

> The incidental expenses of drilling wells, that is, such expenses as are paid for wages, fuel, repairs, etc., which do not necessarily enter into and form a part of the capital invested or property account, may, at the option of the individual or corporation owning and operating the property, be charged to property account subject to depreciation or be deducted from gross income as an operating expense.

Furthermore, the Revenue Acts of 1918 and 1921 implicitly indicate that Congress considered IDC's to be deductible. (Revenue Act of 1918, Sec. 214(a)(1); Revenue Act of 1921, Sec. 214(a)(1)).

Although accounting practices and theories may have changed over the years, the policy to develop our Nation's mineral resources still supports the need for rapid recovery of IDC's for tax purposes. The element of high risk is still present inasmuch as oil and gas deposits have become even more difficult to find. The costs of drilling have escalated. Greater logistical and technological problems are encountered today as the industry must drill deeper and drill in more hostile offshore and frontier environments.

IDC's As An Item of "Tax Preference"

Under present law, the amount by which the "Excess IDC's" exceed the net income from oil and gas properties during the year is a so-called "tax preference" item for individuals. (I.R.C. Sec. 57 (a)(1)) "Excess IDC's" are deductible IDC's incurred during the taxable year less the amount, if any, that would have been deductible in the same year if the taxpayer had amortized the expenses for that year over 120 months beginnning with the month of first production (or, if the taxpayer so elects, less the amount of cost depletion that would have been deductible rather than the 120-month amortization). Since only the first year's allowance for cost recovery is recognized for minimum tax purposes, the amount of the IDC preference is substantially overstated. The IDC tax preference under current law, however, does not apply to corporations with the exception of personal holding companies and Subchapter S corporations.

Because operating costs, overhead, and other taxes are relatively fixed expenses beyond the control of the producer, the only area of planning future expenditures where significant discretion exists is with regard to exploration and drilling budgets. Consequently, this activity is hypersensitive to any changes in tax treatment. The most cursory consideration would indicate that, at the very least, increasing tax liability of explorer-producers would result in a corresponding decrease in exploration and drilling activity. Experience bears this out. In 1969 the statutory rate of percentage depletion for oil and gas was reduced from 27 1/2 percent to 22 percent or a reduction of 20 percent. The following year, 1970, exploratory drilling in the U.S. dropped

21 percent, the biggest drop in a single year in the history of the petroleum industry. In 1971, a further 10 percent decline in exploration drilling was experienced. Fortunately, the fall off in exploratory effort was moderated by minor price increases.

In October 1975, intangible drilling costs for individuals were subjected to the present minimum tax provision. Fortunately, prices for oil and natural gas were increasing which significantly softened the blow, but even so the operating rig count declined sharply throughout the first half of 1976 to a level previously attained in mid-1974. Once again the victim was exploratory drilling which was esentially at the same level of the previous year although there was a rise of over 2,300 in total wells drilled.

It is significant that subjecting intangible drilling costs to negative tax treatment will impact most heavily on newer, and the more aggressive companies actively engaged in development of new oil and gas reserves, in contrast to less aggressive companies which are producing existing reserves. New entrants into the exploration-development industry are critical to our continued progress toward energy independence. For many years the ratio of successful well completions has averaged 6.8 per active operator. Consequently, the significant increase in number of successful well completions is directly related to the increase in active operators of record: i.e., the number of new entrants into the business. The number of operators of record increased from 4,793 in 1974 to an estimated 9,600 in 1981.

As in the past, if IDC is subjected to additional negative tax treatment, exploratory drilling likely would be impacted much more severely than development drilling. Producers are contractually obligated to owners of the mineral interest (royalty owners) to fully develop a lease once a successful discovery has occured. Consequently there is less discretion in drilling of development wells than exploratory wells.

Because the minimum tax affects only producing wells and not dry holes, it would encourage the abandonment as dry holes of newly drilled wells which if completed to produce, would be economically marginal. Many new wells are marginal from the first day of production and this negative tax treatment would result in loss of potential reserves and needed production.

While it is impossible to accurately measure the impact that the proposed negative tax treatment of intangible drilling costs would have, there are ways to develop approximations. IPAA requested members of its Tax Committee to voluntarily develop case histories applying the proposed alternative tax treatment of IDC to actual producer tax records for the last taxable year. While the results vary considerably depending upon whether the taxpayer had substantial income from existing oil and gas production or was a new entrant without substantial existing production, the results indicate a resulting reduction in drilling expenditures on the order of 35 percent. This does not take into account the reduction from the psychological impact on outside investors who provide a significant portion of funds available for exploration and drilling activity.

The following example illustrates the impact:

ILLUSTRATION OF ALTERNATIVE MINIMUM TAX

TAX COMPUTATION ON 1981 ACTUAL RESULTS - EXISTING LAW

Income before IDC expenditure	$879,040
IDC deduction	740,456
Taxable income	$138,584
Income tax (corporate rates)	$ 44,498
Less investment tax credit	30,574
Net income tax paid	$ 13,924

TAX COMPUTATION ON 1981 ACTUAL RESULTS - PROPOSED ALTERNATIVE MINIMUM TAX

1/ Taxable income per above	$138,584
Add back IDC deduction	740,456
Alternative taxable income	$879,040
Alternative minimum tax at 15%	$131,856
Increase in tax burden ($131,856 - $13,924)	$117,932

Effectively, the expenditure of $256,374 in IDC would result in no positive income tax benefit, but instead create $117,932 of additional tax liability (256,374 x .46 = 117,932).

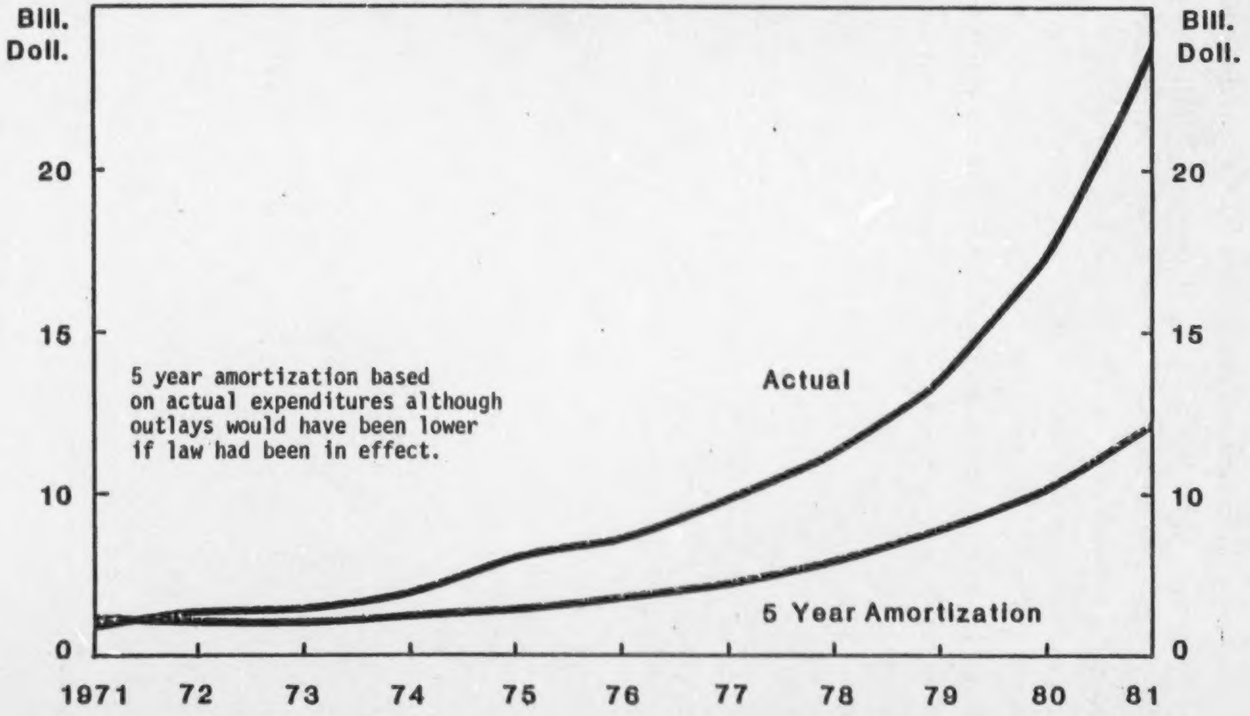
1/ If percentage depletion had been utilized, the excess above cost depletion would be subject to the same "add back" treatment.

Some have recently suggested that intangible drilling costs be included within the present 5 year ACRS treatment. A comparison of (1)(a) expenditures for and (b) the number of successful oil and gas wells completed each year for the period 1971 through 1981 with (2)(a) expenditures for and (b) the number of wells which could have been completed under 5 year ACRS treatment of IDC is very revealing. In 1981, for example, some 55,500 successful wells were actually completed compared with only 21,000 which could have been completed under the ACRS treatment. The impact on our domestic energy supply situation would be very damaging.

(Charts 9 & 10)

INTANGIBLE DRILLING COSTS

ACTUAL EXPENDITURES VS. REDUCED SPENDING
IF IDC SUBJECTED TO 5 YEAR ACRS

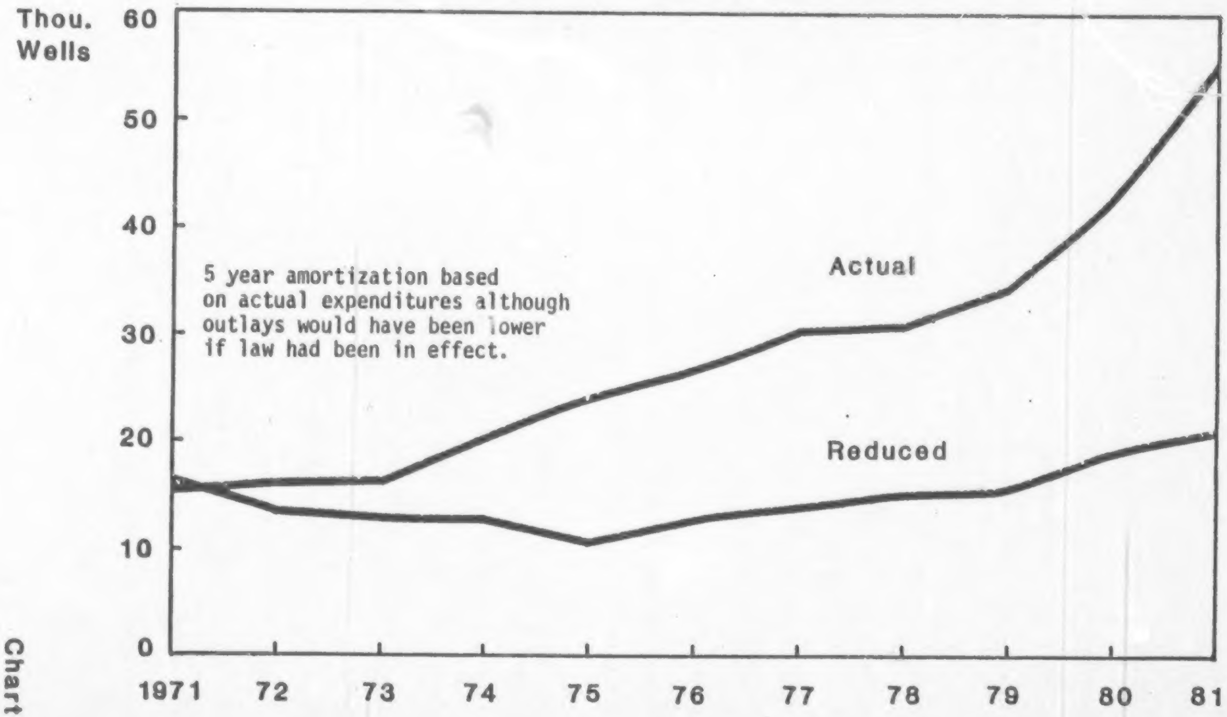


5 year amortization based
on actual expenditures although
outlays would have been lower
if law had been in effect.

Chart 9

SUCCESSFUL OIL & GAS WELL COMPLETIONS

ACTUAL COMPLETIONS VS. REDUCED SUCCESS
IF IDC SUBJECTED TO 5 YEAR ACRS



5 year amortization based on actual expenditures although outlays would have been lower if law had been in effect.

Chart 10

Whereas, in 1980 for the first time in fourteen years, new reserves added equalled actual production for that year, it is probable that both domestic production and reserve additions would have continued to significantly decline requiring the importation of substantially more foreign oil, at minimum. Had this situation existed, in all probability there would today not be a glut of crude oil on the world market, and crude oil prices would not have declined approximately 20 percent from the levels of one year ago. Indeed, they probably would now be much higher than last year. Our balance of payments, trade deficits, and budget deficits would be substantially greater than they presently are. The prospects for economic recovery generally would be severely hampered by our continued strong dependence on imported oil which would be continuing to increase in price.

Of all the preference items subject to the existing minimum tax or suggested for inclusion in the new alternative minimum tax, intangible drilling costs and mining exploration and development costs are clearly distinguishable from the others. These items are not so-called "artificial accounting losses" related to capital investments typically made in highly leveraged transactions utilizing borrowed funds and resulting in the creation of tangible assets having a useful life much longer than the period allowed for amortization. IDC requires the direct investment of whole dollars derived from current internally generated cash flow or outside investor venture funds. For the typical oil and gas explorer-producer, the expenditure of IDC must be repeated in a never ending cycle in order to remain in business.

Negative tax treatment of intangible drilling costs would be self defeating in that it would result in an ever decreasing level of expenditures reducing both the direct revenues anticipated from the minimum tax and ordinary income taxes which would decline due to further reduction in income from oil and gas production.

Minimum Tax Treatment of Percentage Depletion

The concept of depletion has been part of the tax code since adoption of the 16th Amendment in 1913. It is the means provided in the tax code to rrecognize consumption of a physical asset as it is removed or produced from the ground. The present mechanism of percentage depletion was adopted in 1926 for crude oil and natural gas, together with some 105 other extractive minerals after the Department of Treasury and taxpayers agreed that the previous "discovery value" method could not be reasonably administered. Present law provides that as minerals are produced and sold, a specified percentage of the proceeds of sale is considered as a return of capital and deducted from gross income. Since 1975, percentage depletion for crude oil and natural gas has been available only to independent producers and royalty owners.

This represents one of the most important sources of cash flow to finance new exploration and drilling activities. However, there are several limitations and restrictions, mostly added since 1968, which significantly reduce its effectivness as a capital generation tool. These limitations are:

1) For each producing property the amount of percentage depletion cannot exceed 50 percent of the annual net income from that property;

2) For each taxpayer, the total percentage depletion from all properties cannot exceed 65 percent of that person's taxable income;

3) Percentage depletion in excess of cost depletion is subject to the 15 percent add on "minimum tax" penalty;

4) Percentage depletion is available on not more than 1,000 BPD of crude oil or natural gas equivalent;

5) For oil and natural gas alone out of the 105 minerals eligible for depletion, the applicable rate — 27 1/2 percent until 1969 — is being reduced in steps from 22 percent in 1980 to 15 percent in 1984 and thereafter;

6) When a producing property is sold or otherwise transferred (except in very limited "paper" transactions) production therefrom loses eligibility for percentage depletion.

By its very nature, changes in percentage depletion have a magnified impact on cash flow. Consequently, as demonstrated above, the level of domestic exploration and drilling activity has reacted very quickly to reductions in the effectiveness of percentage depletion. Therefore, subjecting percentage depletion to the alternative minimum tax would be counterproductive.

Mr. **Unsell**. Mr. Chairman, the Nation's independent oil and gas producers are doing the job that many said couldn't be done. And they appeal to this committee for some breathing room on tax policy so they can demonstrate that not only can we build the rigs, not only can we find the steel, not only can we train the people, not only do we have the prospects to drill, but we can give them the chance to significantly further reduce our still unacceptable dependence on foreign oil produced by unstable and often unhostile governments.

That concludes the summary of my statement.

The **Chairman**. Thank you, Mr. Unsell. Your entire statement will be made a part of the record.

Mr. Fuller.

STATEMENT OF REX FULLER, CHAIRMAN, NATIONAL ENERGY POLICY COMMITTEE, TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION, AUSTIN, TEX.

Mr. **Fuller**. Thank you very much, Mr. Chairman.

Mr. Chairman, members of the committee, our concern at this hearing is directly to the design of the alternate minimum tax proposal which will require corporations to pay a 15-percent levy on unexpended tax credits. Although we understand the country's need for increased tax revenues, we do not believe that the proposal is in the Nation's best interest.

As independent oil and gas producers, we are specifically concerned by the inclusion in the tax base of the excess of percentage depletion over the adjusted basis of mineral properties and the excess of intangible drilling costs, IDC's, over straight line, 10-year amortization of such costs.

In 1976, independents who operated on an individual basis were burdened with similar limitations regarding their minimum tax requirements. However, it was soon discovered that this discriminatory treatment of individuals could cause a decline of 20 to 30 percent in domestic drilling rates. Ameliorating legislation, carried by Senator Bentsen, in the following 3 years eased the burden on individual independents by lessening the IDC preference element in the minimum tax structure.

While independent operators have learned to live with this version of the tax on IDC's, there is little doubt that any reduction of the IDC expensing incentive and percentage depletion incentive could result in less domestic drilling. The reduction could be especially severe where completions of stripper wells and other marginal properties are concerned. Revenue at the wellhead is an important source of capital.

New congressional attacks on tax incentives for drilling also constitute poor timing. Crude oil prices have declined in excess of 20 percent within the past year, and most experts agree that the end of the drop is not in sight. One of the immediate consequences of this is a sharp reduction in domestic drilling activity. Although imports are currently at a relatively low level, reduced drilling can only lead to the need for more imports when supply and demand resume a balanced status. Reduction or elimination of tax incentives for drilling would only worsen the situation.

We feel that these negative effects are a sufficient argument against either including IDC expensing or percentage depletion incentives in the minimum tax structure. In addition, however, we believe that including IDC's would be unfair and contrary to the theory behind a "minimum tax."

As I understand it, a minimum tax is generally imposed only on artificial losses which are deductions from income but have not required a direct cash outlay. Taxation of legitimately paid expenses, however, is contrary to this objective. Such taxation does not further the purpose of a minimum tax, which is to insure that those who escape taxes because of artificial deductions will nevertheless pay a substitute minimum tax.

There is no justification for taxing corporate IDC's without regard to their connection with oil and gas exploration. Where individuals are concerned, the focus of the minimum tax is at least limited to the IDC deductions which are not linked with oil and gas income. Independents operating as corporations deserve equal treatment.

A few moments ago I referred to the threat of international collapse in crude prices. This, combined with the Nation's need for revenue to cope with budgetary deficits, suggests that the time may have come to initiate a substantial tariff on imported oil and oil products. Such a move would serve the Nation's security by encouraging maximization of domestic energy, raising considerable Federal revenue through both the fee and the consequent preservation of crude oil windfall tax revenue, and encouraging continued conservation of energy by American consumers.

Members of this committee are probably aware that windfall tax revenue declines some $1.4 billion for every $1 drop in the domestic crude price. This could be a substantial loss to the Government should crude prices continue to edge toward the $25-per-barrel range.

This approach would not result in prices to the American consumer higher than what he experienced as recently as December 1981. Furthermore, it would provide energy revenue for the Nation's needs without endangering the vital function of domestic drilling operations. Conservation objectives would be served, and alternate fuel development would not be devastated as will otherwise be the case.

We respectfully appreciate this opportunity to be heard, and thank you.

[The prepared statements of the previous panel follow:]

Statement of Lloyd N. Unsell
Before the Senate Finance Committee
March 18, 1982

My name is Lloyd N. Unsell. I am representing the Independent Petroleum Association of America (IPAA), a national organization of independent petroleum explorer-producers, having almost 8,000 members in every producing area in the nation. Together with the thirty unaffiliated state and regional associations which join us in these comments, we represent essentially all of the 15,000 independent oil and gas producers who account for about 90% of all the drilling in the United States. We welcome and appreciate this opportunity to express our views on tax policy issues under consideration by this committee.

In recent years, a number of tax changes negatively impacted on domestic petroleum exploration and development and have caused a yoyoing effect on industry expenditures and activity. I will cite only two examples:

(1) Oil and gas depletion was singled out for reduction in 1969, and this action was followed in 1970 and 1971 successively by the two largest drops in exploratory drilling in the history of the industry.

(2) In 1976, exploration and development expenditures by independent producers increased by 71 percent over the previous year, 1975. But in October 1976, Congress subjected intangible drilling costs to the 15 percent minimum tax, and in 1977 exploration/development expenditures by independents increased by only 6 percent from the previous year.

Recognizing that this latter provision impacted most severely on those most vigorously exploring for new petroleum resources, Congress partially corrected the disruptive impact of the minimum tax on IDC's in 1977. Later I will discuss our preliminary conclusions on the impact of the pending "alternative minimum tax" proposal which we believe would more seriously impair exploration/drilling activity than the 1976 provision.

As we know from experience following previous changes in energy tax policy, it can take years for the industry to adjust to such changes because oil and gas exploration is a capital intensive activity involving long lead times. The industry is now making solid gains toward significantly reducing dependence on foreign oil. In the past two years, 1980 and 1981, successive records were established in well completions in the United States. In 1980, the industry added new crude oil reserves equivalent to production for the first time in 14 years. We believe when the numbers are in, the year 1981 will have proved to be even better.

Despite the gains stimulated by crude oil decontrol, we must be mindful that the Nation still is importing some 5,000,000 barrels daily of foreign oil. We have a long way to go in restoring relative energy security, and this is no time to create new uncertainty with precipitate new tax changes which are based on revenue considerations alone.

Now, I would like to be more explicit about some of the meaningful gains by the domestic petroleum producing industry.

In my comments I will talk about the exploration-producing segment of our domestic petroleum industry. I will be discussing the benefits to the Nation of our increased activity and how the policies this committee is considering would jeopardize those benefits at a time when we should be consolidating our gains.

Decontrol and higher prices of crude oil have resulted in a booming domestic energy industry. We are resurrecting an industry that was devastated in the 1960's by intolerable economic incentives. Consider the following facts:

- The number of independent producers has increased from 8,300 before the 1973 embargo to more than 15,000 in 1981.
- Employment in the exploration-producing segment of the industry has almost tripled from 1972 through 1982. (Chart 1)
- The number of operating rotary rigs for 1981 was 139 percent above the rig count for 1975. At the end of 1981 the rig count was 4,530. (Chart 2)
- The number of well completions in 1981 equalled 79,000, which represented an increase of 146 percent over 1974. Independents accounted for 95 percent of this increase with the larger companies in the so-called "Chase Bank group" drilling the other 5 percent. (Chart 3)
- But for one of the most onerous taxes ever placed on one industry, the so-called "windfall tax," the record levels cited above would have been much higher.

We think it's important to recognize that at a time when increased investment is so vitally needed in this country domestic producers have responded to improved prices by continually reinvesting wellhead revenues to find and develop more oil and gas. From 1973 through 1979, expenditures for exploration, development, and production by independents have averaged 105 percent of their gross wellhead revenues for both oil and natural gas (Chart 4). Critics said these things couldn't be done. They said that we couldn't get the steel, that we couldn't build the rigs (Charts 5, 6), that we couldn't get the employees, and that we didn't have the prospects to drill anyway. It should be clear by now that those who said these things simply had no faith in the innovative skills and resourcefulness of the American people. It should be clear as well that the only thing we were really lacking was adequate economic incentive, because of counter-productive regulatory and tax policies of the Federal government.

The real question to be asked about this increase in drilling activity and the high levels of investment is "How has the Nation benefited?" We think that the payoff has been dramatic.

- Based on the experience of recent years, for each 1 billion dollars spent on finding and developing crude oil and natural gas, an additional 20,000 barrels of daily production of crude oil equivalent can be established during the next 10 years. This 20,000 barrels of production will back out 3.9 billion in imports.
- In 1980 the domestic oil industry added crude reserves equivalent to production for the first time since 1966. (Chart 7)
- Increases in drilling activity have also resulted in significant economic benefits to the Nation. Increasing the supply of domestic petroleum has not only benefited those industries that use energy as a significant element in production, but also other industries more directly. For example, the petroleum industry is an important user of steel. During the period from 1976 to 1981 this use doubled. As a matter of fact, in last Sunday's Washington Post an article appeared describing how an abandoned steel mill was being renovated to produce oilwell casing. As a result, 500 new jobs will be created. That article is attached.
- Areas of the country that have been hurt by the recession have been helped by extensive new leasing and drilling activity. For example, leasing activity is going on in New England and in the Pacific Northwest, areas long ignored for oil and gas potential. Drilling and production has been significant in areas like Appalachia and the Midwest, especially in states such as Michigan and Ohio that experienced a drilling boom in 1980 and 1981.

Although the industry has made impressive progress, a continuation of these trends is by no means certain. A strong price incentive has had a powerful impact on new investment commitment in the oil industry, including a pronounced surge in drilling activity, accelerated programs in enhanced recovery of known oil reserves, and sharply increased interest in federal lease sales. However, as you've been reading about, crude oil prices have been dropping in response to the so-called "oil glut." As a matter of fact, the price of "new" oil has declined from 39 dollars in early 1981 to 30 dollars today. The impact of this decline is greatly reducing cash flow for producers which in turn will jeopardize future drilling activity. In fact, in the first several months of this year, drilling has already significantly declined (Chart 8). The number of idle drilling rigs today stands at approximately 1,400. The number of idle rigs presently is about the same as the total number of operating rigs in 1974. This drop in the rig count follows an almost uninterrupted increase that began in mid-1979. One of the factors influencing this drop is the uncertainty involved in the budget deficit and tax policy discussions which are on-going in Congress.

With this background, I will address the specific proposal concerning the minimum tax and its impact on intangible drilling costs (IDC's).

In general, the proposed application of a minimum tax to IDC's will be to greatly reduce the funds available for reinvestment in exploration and production as well as to encourage abandonment (as dry holes) of many newly drilled marginal wells.

Generally, intangible drilling costs are those expenditures incurred for materials and services used in drilling oil and gas wells and preparing them for production but having no salvage value upon abandonment of the well. IDC's usually equal about 70 percent of total cost for onshore wells. Examples of IDC's include labor, fuel, drilling mud, cement, and all contractor services.

The current minimum tax proposal would reduce dramatically both the internally and externally generated funds which are available for reinvestment in exploration and drilling. Internally generated funds are affected because this tax applies to actual "out of pocket" direct current expenditures of whole dollars as opposed to deductions from income which do not require a current direct cash outlay. This treatment is contrary to the traditional concept of a minimum tax to insure that those who would not otherwise pay taxes because of high preference income on "artificial losses" would pay some tax. In most other instances a minimum tax is imposed only on artificial losses, but not on those costs that require current cash outlays.

Externally generated funds would be substantially reduced because this proposal would discourage and reduce the outside risk capital available to independent producers. Because the minimum tax on IDC's would apply only to producing properties and not to dry holes, it will encourage the abandonment as dry holes of newly drilled wells which, if completed to produce, would be economically marginal. This will result in a substantial loss of potential reserves and needed production. Because of its complexity detailed analysis of the impact of this proposal has not been possible. However, preliminary study indicates that the negative impact on expenditures for exploration and development could be much greater in magnitude than the tax dollars involved. Several case studies have demonstrated expenditure reductions on the order of 35 percent. We request permission to submit a detailed analysis later.

We are still dependent on insecure foreign sources by about five million barrels per day. As we know from the past, turmoil in the Middle East can disrupt foreign supplies overnight. We urge you to give careful study to any tax proposal that would impact negatively on domestic exploration, drilling, and development.

THE WASHINGTON POST Sunday, March 14, 1982

Hunt Energy Insists Risk In Ohio Is No Pipe Dream

By Peter Behr
Washington Post Staff Writer

By nature and practice, Russell W. Spitz is a risk-taker.

As most of Youngstown, Ohio's steel Industry was closing down or moving out, Spitz and his Hunt Energy Co. moved in.

They took over a cavernous, 61-year-old steel mill that had been abandoned by Jones & Laughlin Steel Corp., gutted its insides, and are re-equipping it with modern electric arc furnaces and continuous steel pipe casters. Hunt plans to hire 500 people for the new plant, a helping hand for the Youngstown area, which has lost 11,000 steel-making jobs since 1977.

When completed this fall, the $85-million renovated plant will produce seamless pipe casings to line oil wells, and at the time the project was launched last year that seemed the perfect product.

All through 1981, the demand for the piping, tubing and casing goods used in oil and gas exploration was so heavy suppliers couldn't keep up. Along with Hunt, many large and small steel producers were planning new production facilities to supply the industry, caught up in a drilling boom because of a three-year rise in petroleum prices.

But Hunt figured to be ahead of many of these U.S. competitors. "Our plan is to get on stream as quickly as possible," said Hunt Vice President Robert Williams. Hunt is counting on its modern equipment and a favorable labor contract it is seeking from the United Steelworkers Union to keep its production costs competitive with other U.S. and foreign producers.

Now, however, the road that looked so straight and smooth last fall has developed some jolting bumps.

Oil prices have been falling since the first of the year, thanks to the worldwide surplus of petroleum products; the U.S. drilling surge has cooled off dramatically, and orders for steel pipe have plummeted. After three months of this decline, steel pipe producers now face a huge backlog of inventory, estimated at 5.5 million tons—more than a year's production for domestic steel companies—according to Peter F. Marcus, a steel industry analyst with Paine Webber Mitchell Hutchins Inc.

Quanex, a Texas oil field pipeline manufacturer that was to have had invested $15 million in the Hunt venture for a one-quarter share of the project, pulled out in January.

Despite these reversals, Hunt Energy has not lost faith in its venture, Williams said.

Other financial investors have replaced Quanex, and even without the Texas company, Hunt has contracts now to sell the first two years' production from the plant and those contracts are holding firm.

And Hunt believes it can ride through what it believes will be a temporary slowing in domestic oil and gas drilling. The larger diameter casings it makes are not in such great supply—moreover, casings cannot be reused, while drill tubing is.

"I'm not saying there are no risks. But our feeling is, the more we work with this, the more we feel this mill is a model for the future," he said.

It isn't that risk makes the company shudder. Spitz was a 38-year-old Milwaukee certified public accountant and entrepreneur when he took over the Hunt Valve Co. in 1974. Then it was a backwater manufacturing firm with annual sales of about $2 million, receiving little attention from its parent company, Bellows International.

The financial controls on Hunt then were so tight it couldn't grow, said Williams. There was little research investment or interest in new products. "It was impossible to get any engineering done," Williams said. So the company pumped along with the same product line of industrial valves.

Spitz took the wraps off, Williams said. Instead of waiting for customers' orders, it began designing complex valve systems for steel mills and selling the entire packages, thus eliminating some of their customers' engineering expense. Their list of customers grew to include most of the major steel makers in Japan and Brazil as well as the U.S. industry.

"We upgraded our products—it hadn't been done in 20 years. We built up inventory and reduced delivery time to four weeks [it had been 48 weeks for some products]. It was a risk, but we knew we were serving the steel industry, and we had to have parts and people available."

In the last three years, Hunt invested in computer controls for its cutting and shaping equipment to improve quality and sophisticated computer-aided design terminals.

The results were dramatic, Williams said. Before 1974, they were lucky to sell a dozen of their best quality valves a year. Since 1978, more than 500 have been sold. "We started at $2 million. Today we make $30 million in the valve business alone."

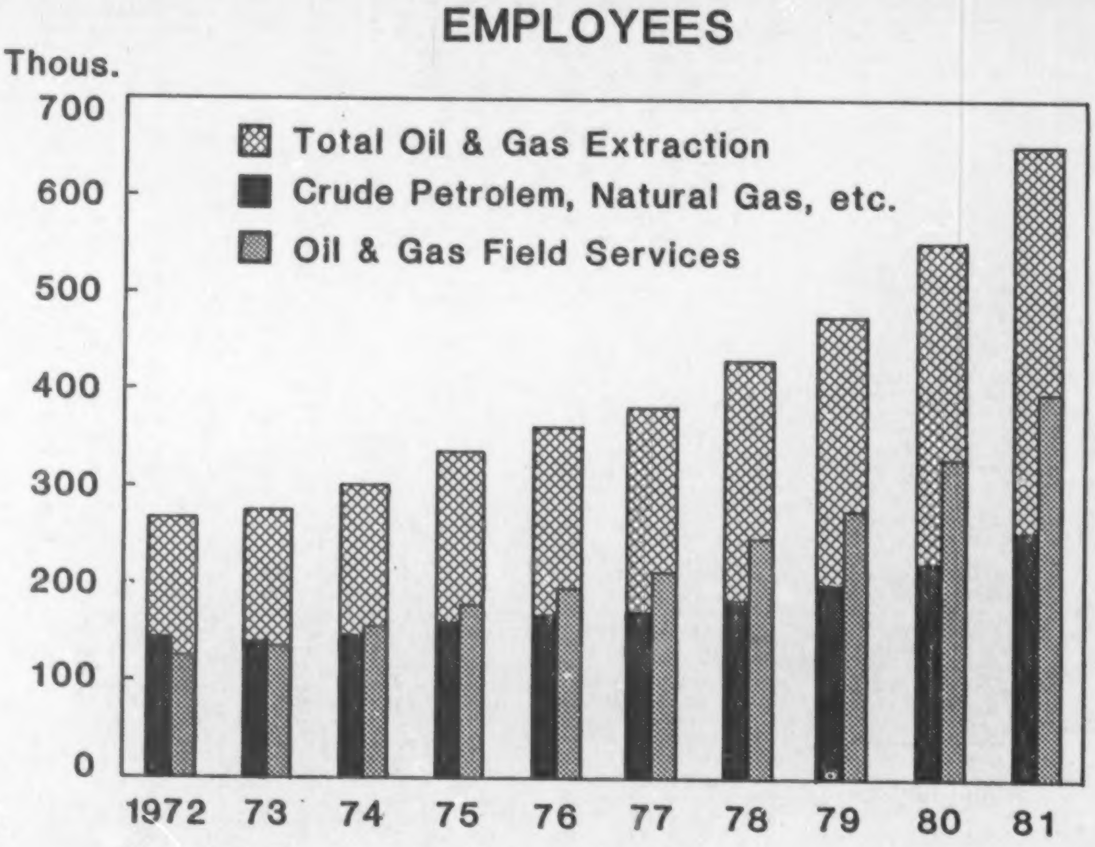
Seeing an eventual slowdown in that business, Hunt turned to pipe production, Williams said, believing that it understood steel-making technology from its experience producing valve systems for the industry.

They saw a bargain in the huge Brier Hill steel plant that was closed by Jones & Laughlin in 1979. "You couldn't put that building up for $20 million today," Williams said. Where that was a basic steel plant, melting ore to make ingots and casting these into shapes, the Hunt process begins with steel scrap that will be dumped from trucks into the tops of two electric arc furnaces.

Molton steel flows from the furnace bottoms and is turned into seamless pipe through a continuous casting process that eliminates several major, costly steps required in the old steel-making technique and improves the quality of the final product as well.

Williams remains confident that steelworkers will agree to work under a fabricators contract rather than the basic steel industry agreement, giving the new plant approximately the same labor costs as a nonunion mill.

If steel prices recover to last year's levels and shipments reach Hunt's goals, the $85 million investment could be recovered in about three years, Williams said. That makes it a risk well worth taking, he says.



Source: Bureau Of Labor Statistics

Chart 1

ROTARY RIGS ACTIVE IN U.S.

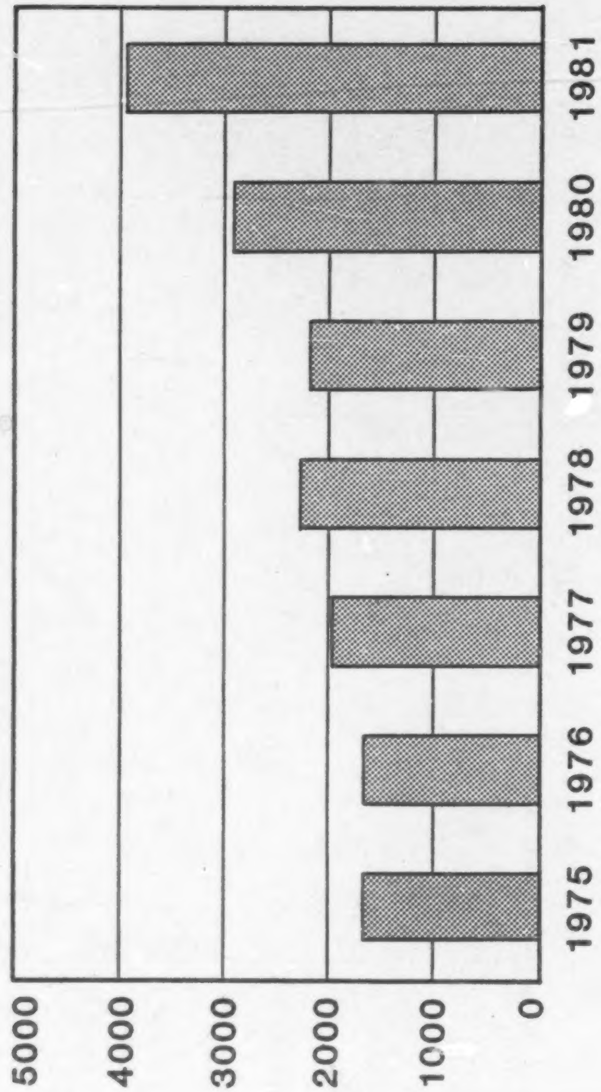
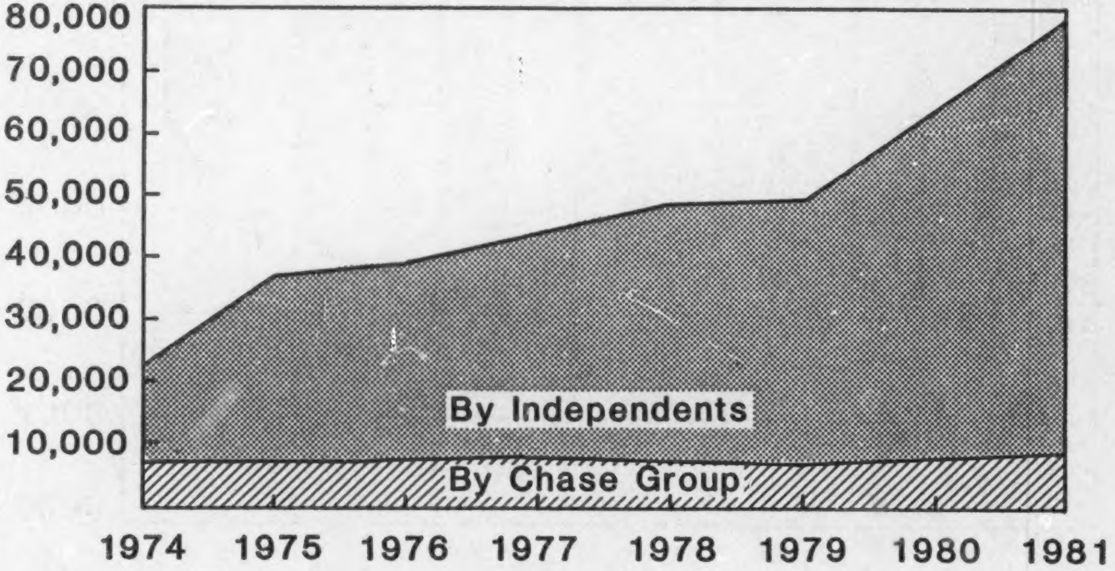


Chart 2

TOTAL WELLS DRILLED FOR OIL &GAS

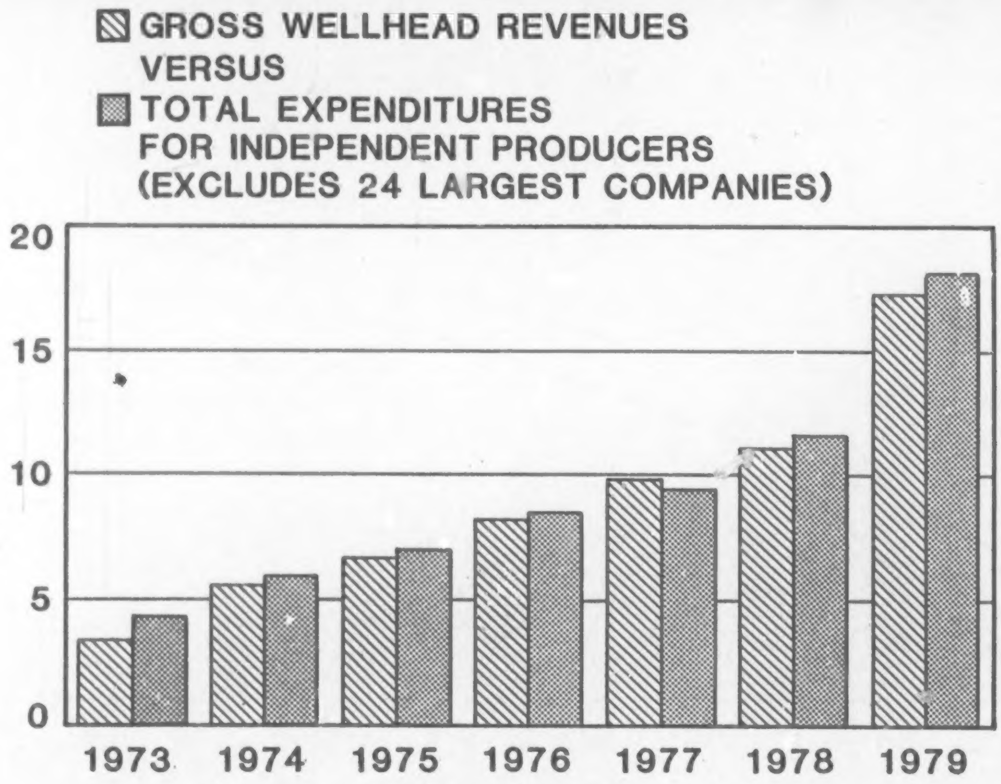
(Chase Bank Group of Co.'s vs Independents)



Source: Petroleum Information Inc.

Chart 3

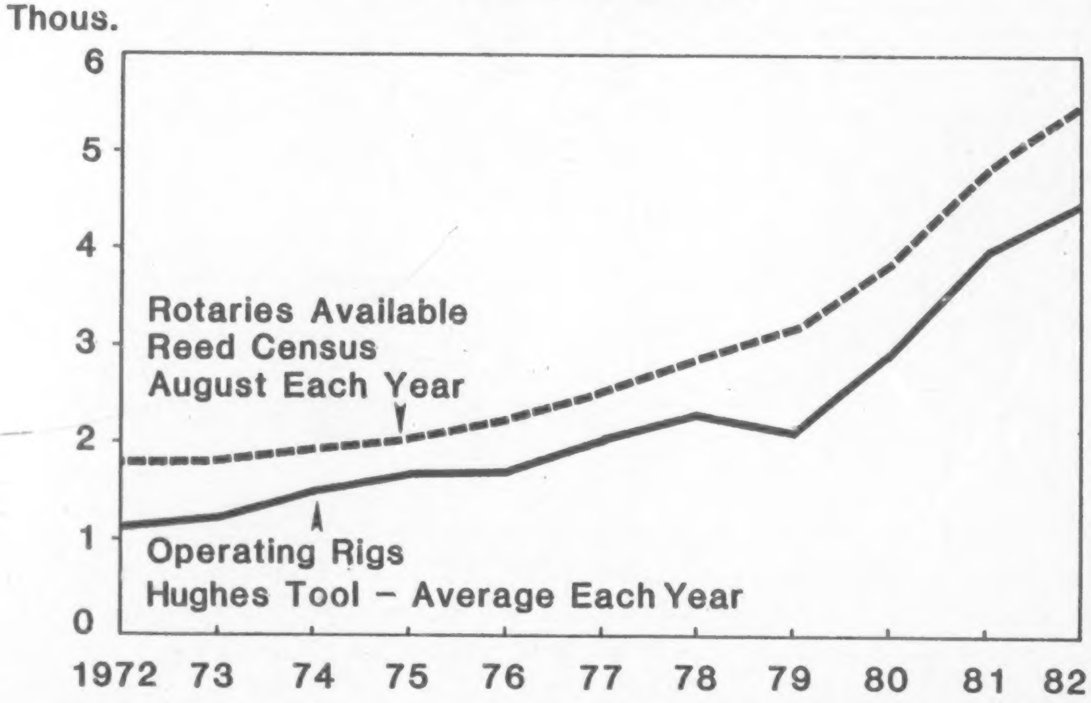
Chart 4

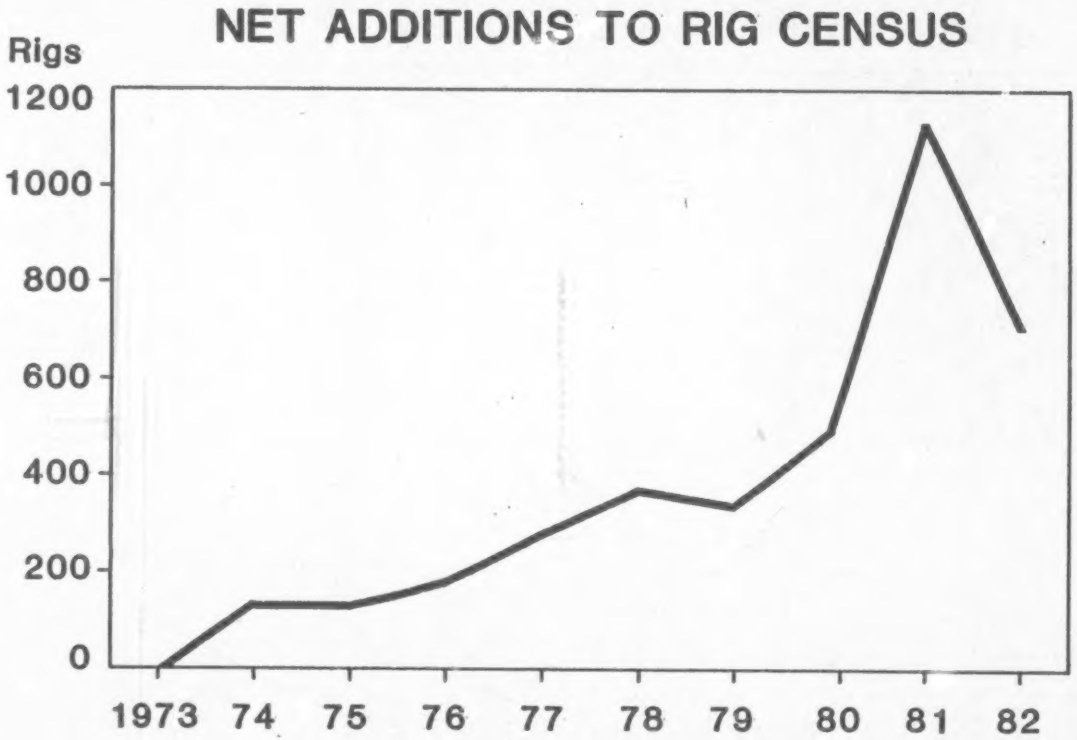


Source: Bureau of the Census

Chart 5

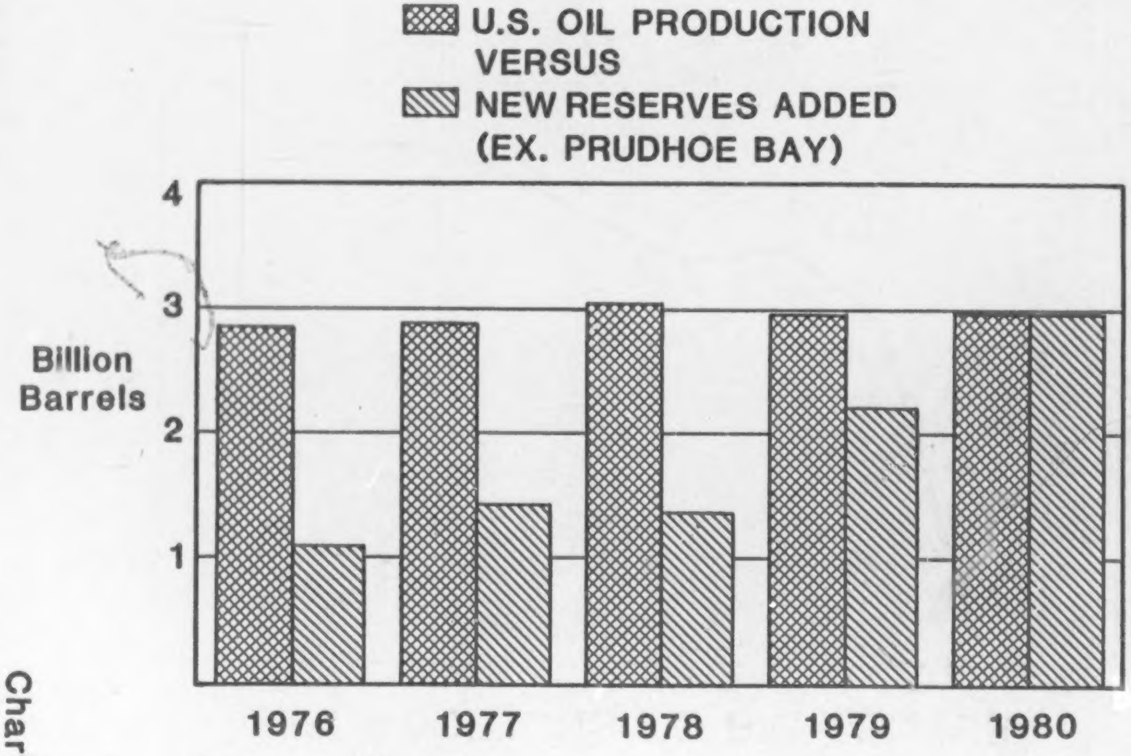
ROTARY RIGS





NET ADDITIONS TO RIG CENSUS

Chart 6



Source: API-DOE

Chart 7

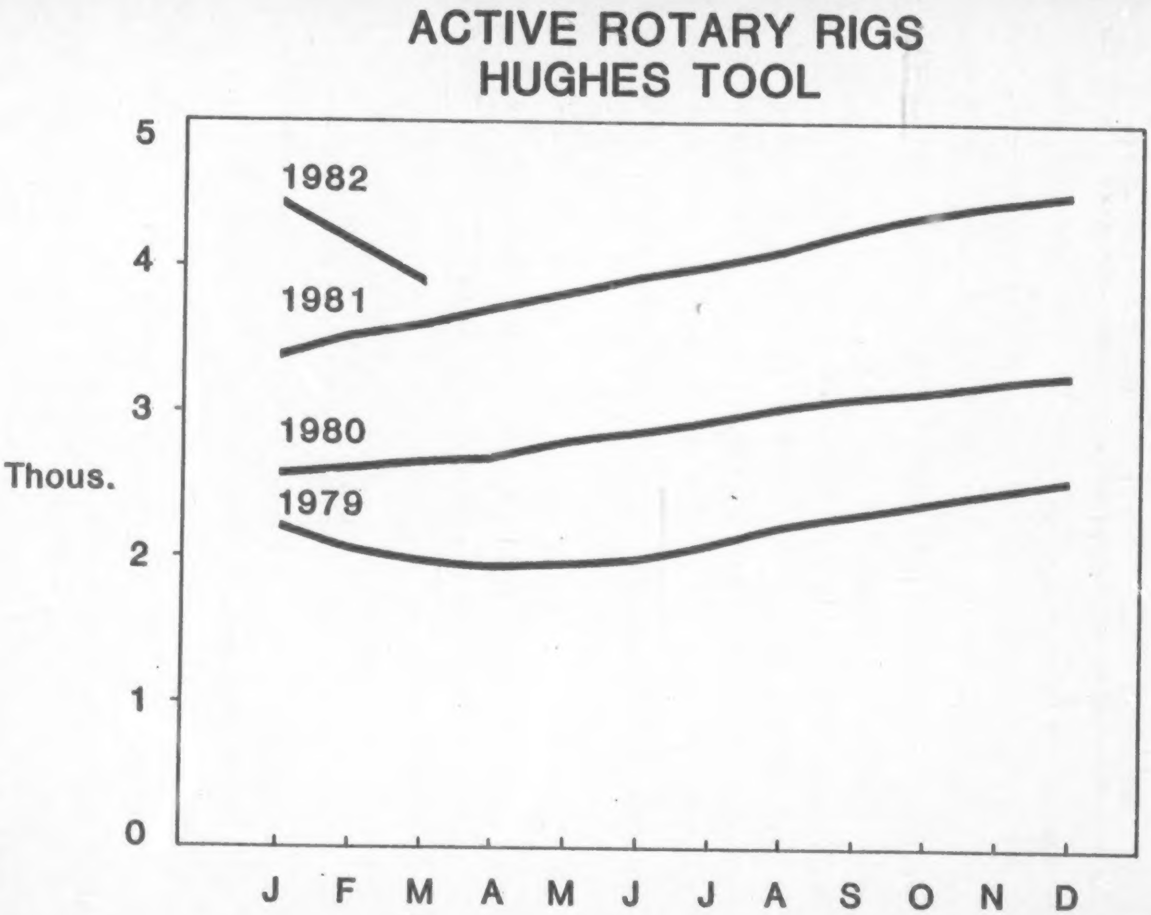

ACTIVE ROTARY RIGS
HUGHES TOOL
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Chart 8

Statement by Rex Fuller, Chairman, National Energy Policy Committee, Texas Independent Producers and Royalty Owners Association, Austin, Tex.

Mr. Chairman and Members of the Committee:

My name is Rex Fuller, independent petroleum producer from Lubbock, Texas, and I appear here today on behalf of L. Frank Pitts, president of the Texas Independent Producers and Royalty Owners Association (TIPRO). I am chairman of the Association's National Energy Policy Committee. TIPRO is composed of 5,200 members who have petroleum interests in Texas.

Our concern in this hearing is directed to the design of the Alternate Minimum Tax Proposal (AMT) which would require corporations to pay a 15 percent levy on an expanded tax base. Although we understand the country's need for increased tax revenue, we do not believe that the proposal is in the nation's best interest.

As independent oil and gas producers, we are specifically concerned by the inclusion in the tax base of the excess of percentage depletion over the adjusted basis of mineral properties and the excess of intangible drilling costs (IDCs) over straight line, 10-year amortization of such costs. Many independents are incorporated for exploration and development purposes and rely directly on percentage depletion and expensing of IDCs to maintain current expansion of domestic drilling activity. Without this expansion in activity, the nation would be forced to rely more on insecure, expensive oil imports.

In 1975, independents who operate on an individual basis were burdened with similar limitations regarding their minimum tax requirements. However, it was soon discovered that this discriminatory treatment of individuals could cause a decline of 20 to 30 percent in domestic drilling rates. [Remarks of Senator Bentsen, 123 Congressional Record no. 71 (95th Cong., 1st Sess., April 28, 1977).]

Surveys in 1975 supported the contention that domestic drilling would decline by one-third if independents were forced to capitalize IDCs. Ameliorating legislation in the following three years eased the burden on individual independents by lessening the IDC preference element in the minimum tax structure. This was done, in essence, by reducing their IDC preference item on a property-by-property basis by their net oil and gas income as defined in the law. IDC expenditures on properties which do not produce were not charged a minimum tax.

While independent operators have learned to live with this version of the tax on IDCs, there is little doubt that any diminution of the IDC expensing incentive and percentage depletion incentive would result in less domestic drilling. The reduction would be especially severe where completions of stripper wells and other marginal properties are concerned. Independents drill virtually 90 percent of the nation's oil and gas wells and have, since 1975, spent some 105 percent of what they earn at the wellhead in drilling operations. Revenue at the wellhead is the primary source of capital. Thus, the less they receive, the less they drill.

The negative effects of such a result are worth dwelling on. Nothing could be more self-defeating than to drain away our capacity for developing energy at the very time the nation is trying to cope with economic decline. Reduction in domestic exploration and development of petroleum can only aggravate unemployment trends and the nation's balance-of-trade deficits. This is so because the country would be forced to turn to imports more and more to meet the demand for energy. Furthermore, it is conceivable that sharp declines in domestic drilling combined with an international crisis could eventually cause severe shortages similar to those experienced during the last decade. Such an experience would only lead to another devastating round of high prices and inflation in the years ahead.

New Congressional attacks on tax incentives for drilling also constitute poor timing. Crude oil prices have declined in excess of 20 percent within the past year, and most experts agree that the end of the drop is not yet in sight. One of the immediate consequences of this is a sharp reduction in domestic drilling activity. Although imports are currently at a relatively low level, reduced drilling can only lead to the need for more imports when supply and demand resume a balanced status. Reduction or elimination of tax incentives for drilling would only worsen the situation.

We feel that these negative effects are a sufficient argument against including either IDC expensing or percentage depletion incentives in the minimum tax structure. In addition, however, we believe that including IDCs would be unfair and contrary to the theory behind a "minimum tax."

A typical example of how adverse the inclusion of IDC expensing in the minimum tax structure could be is that of the independent who is covered by the minimum tax and spends $300,000 to "frac" a well. Under a 15 percent rate he would have to pay $45,000 tax on this intangible cost, which clearly constitutes a tax on an expense of doing business.

As we understand it, a minimum tax is generally imposed only on "artificial" losses which are deductions from income but have not required a direct cash outlay. Taxation of legitimately paid expenses, however, is contrary to this objective. Such taxation does not further the purpose of a minimum tax--which is to ensure that those who escape taxes because of "artificial" deductions will nevertheless pay a substitute minimum tax. There is no justification for taxing corporate IDCs without regard to their connection with oil and gas exploration. Where individuals are concerned, the focus of the minimum tax is at least limited to IDC deductions which are not linked with oil and gas income. Independents operating as corporations deserve equal treatment.

We recognize that, if Congress determines that increased tax revenue is necessary to help the country's serious economic ills, the energy sector of the economy will undoubtedly join others in paying the bill. If the taxing solution is broad-based, such as a surtax on income tax or a national sales levy in some form, we will not appear in search of exemptions. It is another thing, however, to seek energy's tax help in the form of chipping away at existing tax code incentives which encourage domestic drilling.

A few moments ago, I referred to the threat of an international collapse in crude prices. This, combined with the nation's need for revenue to cope with budgetary deficits, suggests that the time may have come to initiate a substantial tariff on imported oil and products. In one stroke, such a move would serve the nation's security by encouraging maximization of domestic energy, raising considerable federal revenue through both the fee and the consequent preservation of crude oil windfall tax revenue, encouraging continued conservation of energy by American consumers, and discouraging OPEC from raising prices in the future.

Members of this Committee are probably aware that windfall tax revenue declines some $1.4 billion for every $1.00 drop in the domestic crude price. This could be a substantial loss to the government should crude prices continue to edge toward the $25 per barrel range.

Should an imports fee be pegged at an average crude price of $35 per barrel, the fee would currently provide some $7.3 billion annually. In addition, it would tend to preserve some $5.6 billion in windfall tax revenue from domestic supplies. This estimate assumes that the current average crude price is in the vicinity of $31 per barrel and that crude and products imports will average 5 million barrels per day. For every additional $1 decline in the international crude price, an additional $3.2 billion would accrue to the federal government.

This approach would not result in prices to the American consumer higher than what he experienced as recently as December 1981. Furthermore, it would provide "energy" revenue for the nation's needs without endangering the vital function of domestic drilling operations. Conservation objectives would be served, and alternate fuel development would not be devastated as will otherwise be the case.

At the same time, this solution would alleviate the Congressional tendency to erode drilling tax incentives, attack current exemptions to the windfall profit tax, and devise new forms of energy taxation. All such attempts have a negative, self-defeating effect. The resulting reduction in domestic energy would simply mean an increased need for foreign supply--either immediately or in the not-too-distant future. This would not be in the best long-range interest of the American consumer.

We appreciate this opportunity to be heard.

Respectfully submitted,

Rex Fuller

Rex Fuller
Chairman, National Energy
  Policy Committee
Texas Independent Producers and
  Royalty Owners Association

The **Chairman**. Senator Bentsen.

Senator **Bentsen**. Mr. Fuller, why is the IDC important to independent producers.

Mr. **Fuller**. The importance of the IDC is that this is the mechanism within the tax law that allows him to take risks as opposed to the other investment alternatives that are available to him.

In my opinion, if we were to enact the tax as proposed, we would see a drop in the development budgets of the independent companies to approximately the range of 15 percent. Most of this would be in the marginal and stripper areas. In the exploration budgets, you would see a much more severe drop, probably in the range of 25 to 30 percent. And if you didn't have the right of offset against oil and gas income, it would probably add another 10 percent to that.

Now, if you look from the standpoint of IDC's and did away with them entirely and made them capitalized and depreciated out over a 10-year basis, I think with independents in the exploration budget you would see a 75- to 80-percent drop.

Senator **Bentsen**. What this actually does is provide independent producers with the immediate cashflow necessary for drilling.

Mr. **Fuller**. Yes, sir.

Senator **Bentsen**. And independents reinvest 105 percent of the income they receive?

Mr. **Fuller**. Yes, sir.

Senator **Bentsen**. It is independent producers who do most of the drilling in this country; they attempt to find new sources of oil, and luckily for this country, they do.

Moreover, it is important to recognize that all we are doing is deferring the tax, that ultimately it will be paid. Producers can avoid the tax only by drilling more and more. The day they stop drilling the tax begins to catch up.

Mr. **Fuller**. Very rapidly.

Senator **Bentsen**. So the IOC is really just an incentive to get producers to keep drilling so that this country can achieve self-sufficiency. To the extent we take that incentive away, we reduce the amount of exploration that takes place in this country with the result that we buy more oil from the Middle East. Is that true?

Mr. **Fuller**. Yes, sir, very true.

Senator **Bentsen**. As a consumer I am glad we have the current oil surplus, but it could disappear overnight. It would be foolhardy for us to believe that we can cut back on exploration—or on the incentives for exploration—in this country. That would be a shortsighted policy indeed.

The **Chairman**. I have no questions.

We are looking for revenues. If you have any ideas where you could chip in a little, why, we would appreciate hearing from you. [Laughter.]

Mr. **Unsell**. I think Mr. Fuller just gave you one. And I would like to mention, also, that we have a lot of speculation nowadays, you know. We were focusing a year ago on how high is the crude price going? Now the whole mentality is how low is it going?

The **Chairman**. Well, it was pretty high, so I guess it could drop a little.

Mr. **Unsell**. Recently the Post had speculation, three different speculations in fact, from unnamed spokesmen for big oil companies that it would go to 25, 20 and 15. And I just wanted to mention that for every dollar of decrease in the domestic price, the industry only gets 20 to 29 cents—somewhere in that range. So if you did put an import tax on that saved another $5 erosion, you are not only getting the import fee, you are saving somewhere around $3.60 for the Federal Government in taxes that would otherwise be lost through price erosion.

The CHAIRMAN. Well, that's one of the options being considered. But I think I read this morning where the domestic industry was promoting that for selfish reasons because it raised domestic prices. I am not suggesting this, but it was in one of the columns this morning in one of the papers.

There would be an effort, I assume, on the House side to undo what we did last year in the tax bill, as far as stripper wells, royalty owners and new oil is concerned. I assume you are alert to that.

Mr. UNSELL. Yes, sir.

The CHAIRMAN. It may be tried on the Senate side; I wouldn't rule it out.

Mr. UNSELL. Do you mean suspending what was done last year?

The CHAIRMAN. Yes.

Mr. UNSELL. Yes, we are very much aware of that. And as you pointed out, Senator, you know stripper oil was the only oil being produced in this country that was rolled back when we put that tax on. It was the only oil selling in the free market. And there is a provision on the windfall tax, as you know, that says if your tax exceeds 90 percent of your net income you get a refund. It happens that most of those refunds are on the marginal properties—stripper properties. To the extent that big companies operate stripper properties they have a computer setup where they can punch all that data in and file the very complicated, highly complex arithmetic to claim those refunds. The independents, on the other hand, don't have that capability, many of them, and I think if they did that most of that tax would be reclaimed anyway.

So what I am suggesting is that that is a vitally important provision.

The CHAIRMAN. You don't have to convince the two of us, but I think there are 20-some on the House side in the Ways and Means Committee that need some attention.

Well, we appreciate very much your testimony, and your statements will be made a part of the record.

Thank you.

Mr. UNSELL. Thank you.

Mr. FULLER. Thank you for the opportunity.

The CHAIRMAN. We next have a panel consisting of Mr. Wall, Mr. Frey, Mr. Bedell, and Mr. McGrath.

The CHAIRMAN. Let me say, first of all, that your entire statements will be made a part of the record. If you can summarize your statements it will be helpful.

Thank you.

STATEMENT OF WILLIAM WALL, CHAIRMAN AND PRESIDENT, KANSAS POWER & LIGHT CO., EDISON ELECTRIC INSTITUTE, WASHINGTON, D.C.

Mr. WALL. May it please the committee and Mr. Chairman, my name is Bill Wall. I am chairman and president of the Kansas Power & Light Co. I appear here today on behalf of the Edison Electric Institute, which is the organization that represents nearly every investor-owned electric utility and Federal taxpaying electric utility in the Nation.

My written statement will be filed, but if I could, in these couple of minutes I would like to comment on two of the items: The minimum tax provision and the treatment of industrial revenue bonds for pollution control facilities.

At the very beginning I would like to make it clear that our industry is not opposed to a minimum corporate tax. Other elements of American enterprise may make the case for those preference items that result in some corporate taxpayers paying no tax, but those items simply don't apply to our industry. What we are here objecting to is that in pursuit of the goal of establishing a minimum tax, our industry will be denied the use of the investment tax credits that we have already earned.

If I might, let me please try to describe our situation. As a result of what used to be known as the energy crisis, we have been required by Federal law to stop making electricity out of burning oil and natural gas. And this has meant, to keep the lights on, that we had to begin building coal and nuclear-fired plants and that at enormous cost, recently averaging as much as $30 billion annually. And this massive capital program has seriously hurt the private electric utilities.

Just last year 25 of them saw their credit ratings drop, and nearly every utility stock sells well below its book value. Adding to that have been the rate increases that have been necessary to service that huge investment, with the strong negative reaction that we all know that those have produced.

But we were told that we had to continue, and we have—in the face of high interest rates, environmental objection, record inflation and customer dissatisfaction. Federal tax policy has helped us, however, enormously. Since 1962 we have been able to earn investment tax credits as the result of our construction program and to use those credits up to, this year, 90 percent of our tax liability—not 100 percent; we always pay and will continue to pay a minimum tax.

Now, the administration's proposal would take away the full use of those investment tax credits. Mr. Chairman, if there is one industry that has responded to supply-side economics, I think it has been ours. We have committed billions to a construction program in reliance on tax policies that made it possible to finance them in the first place. And these are construction programs that were required by the public interest. Now, barely a year after the Economic Recovery Tax Act became law, we are threatened with a loss of a large part of the investment tax credits we have already earned.

The administration's proposals insofar as they apply to our industry cannot be justified as a way of putting a floor under corporate taxpaying. As I've said perhaps too often, the preferences in the proposed alternative formula don't apply to us in any significant degree, and we in fact already pay a minimum tax.

But, stripped to the bone, this alternative proposal would deny us the full use of the investment tax credits we have depended upon in our planning and which we think we've earned by our performance.

Now, an additional irony is that it would hurt most the very weakest companies in our industry. This is because the electric utilities with heavy construction programs are, quite naturally, in the worst shape financially. To deny them the benefit of the tax credits their construction programs have earned will only compound the damage to them.

On the other hand, the utilities, and there are many of them, which have finished with their construction program and are in pretty good shape financially could ignore the provision altogether, because they already pay and will continue to pay at a level far above that sought by the administration as a minimum tax.

Now quickly to the proposed restrictions on industrial revenue bonds to finance pollution control facilities by utilities.

Excepting only the so-called two-county rule, which has very limited use, I would ask the committee to apply these tests to industrial revenue bonds to permit them to retain their current character:

First, that the facilities built from the proceeds of the bonds be nonproductive in character and not create any profit for any private party;

Second, that such facilities benefit the general public;

Third, that the facilities built be necessary to meet the requirements of the law, and;

Fourth, that the entity constructing the facilities is not doing so to create a tax shelter.

If these tests can be met, we suggest industrial revenue bonds should retain their current treatment, because the bonds issued by our industry will pass those tests and, in addition, result in lower electric bills to our customers.

Mr. Chairman, thank you very much.

The CHAIRMAN. Mr. Frey.

STATEMENT OF HOWARD H. FREY, VICE CHAIRMAN AND CHIEF ADMINISTRATIVE OFFICER, WESTMORELAND COAL CO., ON BEHALF OF THE NATIONAL COAL ASSOCIATION, WASHINGTON, D.C.

Mr. FREY. Mr. Chairman, I am Howard Frey, vice chairman and chief administrative officer of Westmoreland Coal Co., Philadelphia, Pa. I am testifying on behalf of the National Coal Association. My detailed statement has been submitted for the record.

The coal industry's interest is in preserving an atmosphere of investment incen[illegible] necessary for business growth and development and consistent [illegible] the President's economic recovery program.

Our Nation [illegible] have an ample supply of reasonably priced energy to fuel ec[illegible]ic recovery. Coal, America's most abundant and lowest price[illegible] resource, will play an increasing role in achieving this goa[illegible]rts predict that coal use is expected to double over the next 10 years and will become our leading export commodity.

To produce enough coal to fuel economic recovery and future growth will require at least $50 billion over the next 8 years for new investments in mines and other facilities—roughly 3½ times our present capitalization.

But the fact is, Mr. Chairman, the coal industry is facing large increases in production costs and declining profit margins at the very time when we must plan industry expansion. The highest degree of investment possible is a necessity.

For these reasons we urge the repeal of the present corporate minimum tax and the committee's rejection of the alternative minimum tax, which is being proposed. Both taxes, we believe, are contrary to the goals of sound economic growth. They also work a hardship on low-profit, capital-intensive industries such as coal.

The minimum tax concept would dilute the tax incentives intended to help spur new investments which are central to the Economic Recovery Tax Act of 1981. Coal mining is granted a 10-percent depletion allowance, but few coal producers can take advantage of the incentives offered because of the 50-percent net income limitations.

Our studies show that from 1975 to 1980 the coal industries effective depletion rate dropped from just over 7 percent to just under 5 percent, illustrating the industry's declining profit margins. By adding mining exploration and development costs as a preference item, many coal companies and other mining interests will be further starved for investment capital.

The add-on corporate minimum tax should be repealed, not made more onerous by the Treasury Department.

The coal industry also supports preserving safe harbor leasing. It will stimulate investment in new mines and other facilities, particularly among capital-intensive, low-profit industries such as coal mining.

I understand the logic behind the proposals to repeal this provision, that leasing is a subsidy for the inefficient. But we don't agree with the assumption. I simply want to point out that some companies are paying low tax rates not because they have low taxable income but because they have low profit margins, which is wholly consistent with reasonable tax policy.

Mr. Chairman, I would like to give you a specific example from Westmoreland Coal. At the end of 1981 we had approximately $32 million of unused net operating loss carryforwards and almost $3,700,000 of unused investment tax credit. Westmoreland's pretax losses from operations for the years 1981, 1980, and 1979 were respectably $15 million, $4½ million, and $6½ million.

It takes as much as a decade to bring a new deep mine into commercial production. These future energy realities depend on today's investment decisions, but it is difficult if not impossible to make a wise, sound investment decision if you do not know what the economic and tax policy will be. One of the most pressing goals is to restore stability to our economy and instill more confidence in investment decisions.

We believe the Economic Recovery Act of 1981 is the basis for such a steady, sound course. It is designed in part to spur industrial expansion and to modernize what we are using. Specific provisions of the act are targeted to touch capital-intensive, low-profit industries such as coal.

The coal industry doesn't believe the administration's proposals are consistent with a steady course, and in some instances these changes would leave industry in a worse investment and planning condition than before the act was passed.

We urge that the act be given more time to work its course. One year simply isn't sufficient.

Mr. Chairman, in my detailed statement I have identified three other areas of concern which I ask the committee to consider. For the sake of brevity I will pass them now. This concludes my testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Bedell.

STATEMENT OF DENNIS P. BEDELL, AMERICAN MINING CONGRESS, WASHINGTON, D.C.

Mr. BEDELL. Thank you, Mr. Chairman.

I am Dennis Bedell. I am a member of the law firm of Miller and Chevalier and chairman of the Tax Committee of the American Mining Congress. I appear before you today on behalf of the American Mining Congress, which is the industry association representing all segments of the mining industry.

I would like to direct my remarks to the proposed corporate alternative minimum tax. I briefly note that in the statement we also address two other items of particular concern to the mining industry—the matter of safe harbor leasing, which has been used by a number of our Nation's mining companies to obtain funds for needed capital investment and is very important to the mining industry; also the matter of pollution control bonds which, as I say, are addressed in the statement.

Mr. Chairman, the American Mining Congress believes that the proposed corporate alternative minimum tax is bad fiscal policy and bad tax policy. There are two fundamental facts which demonstrate this, and that is that the proposal would fall most heavily on those companies that are doing precisely what provisions were put into the code to encourage, those companies that in the active conduct of their business are making needed investments, improving their capital, modernizing their plant and equipment, exploring for and developing the Nation's needed minerals.

Also, the corporate minimum tax proposal would fall most heavily on those companies that are in a cyclical business, like the mining business or the steel business, and who are in a depressed profit position, perhaps of current circumstances, perhaps because of operating losses suffered in prior years.

The penalty of the proposal on capital investments is graphically illustrated by a very simple example of a corporation which has no so-called preferences, just a hundred dollars of taxable income. And the $46 of corporate tax that would normally be paid can be reduced by 90 percent to $4.6 by investment credits—investment credits that are generated as a result of making capital investments to improve and modernize plant and equipment.

The corporate minimum tax would triple the tax of that taxpayer from $4.6 to $15—no preferences, just making needed investments. The penalty that the proposal would impose on capital investments is a direct reversal of the thrust of the legislation last year embodied in the Economic Recovery Tax Act to encourage the modernization of our plant and equipment.

I would also point out, Mr. Chairman, that the proposal to reverse this thrust creates an instability in the investment climate that is reminiscent of the late 1960's and the early 1970's, when we had the off-again, on-again investment credit. It's here, then it's gone. The instability makes it most difficult for business generally to plan and particularly for the mining industry to plan for needed capital investments where, as Mr. Frey mentioned, a tremendously long leadtime is involved between the time of discovery, development, and operation of a new mine.

The Economic Recovery Tax Act enactment of the accelerated cost recovery system and the investment credit were of little direct benefit to the mining industry because of the depressed profit position which the industry is in.

The safe harbor leasing provision has provided some funds and some benefit of those provisions to the mining industry.

The proposed corporate minimum tax, however, would fall heavily on the mining industry. So we would have the inequitable situation of an industry receiving little benefit from last year's tax provisions and suffering a substantial portion of this year's tax burden.

And for those reasons, Mr. Chairman, we strongly oppose the proposal for the corporate alternative minimum tax.

I thank you.

The CHAIRMAN. Senator Heinz is here. He must leave and is coming back. He just wanted to say a word or two.

Senator HEINZ. I just wanted to welcome Mr. Frey of the National Coal Association with whom my staff and I have had an opportunity to work in the coal conference.

We are glad to have your testimony, Howard.

Mr. FREY. Thank you, Senator.

Senator HEINZ. I'm sorry I got here a few minutes too late to hear it. I will be sure to get a copy.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. McGrath.

STATEMENT OF JEROME J. McGRATH, PRESIDENT, INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA, WASHINGTON, D.C.

Mr. McGRATH. Thank you, Senator.

My name is Jerome McGrath. I am president of the Interstate Natural Gas Association of America.

With me today, on my right, is John W. Faircloth, vice president of Taxes of Columbia Gas System Service Corp.

INGAA is a nonprofit trade association whose membership consists of virtually all of the major interstate natural gas transmission companies in the United States, accounting for over 90 percent of all the gas that is transported and sold in interstate commerce.

I am appearing here today to discuss three provisions of the administration's tax proposals: The new corporation minimum tax, the repeal of the energy tax credit, and the proposal to require corporations to pay 90 percent of their estimated tax liability.

I would like first, Mr. Chairman, to make two basic points, however. One is that we recognize the real political and economic problems faced by this committee and the Congress in attempting to reduce the anticipated budget deficits.

The second is that the pipeline, the natural gas pipeline, industry has been and will continue to be a substantial taxpayer for many, many years.

We are opposed to the enactment of the alternative minimum corporation tax because we believe that such legislation will deter or discourage efforts by our industry to make this Nation more energy self-sufficient.

Just a very few years ago energy shortages were an all too common occurence throughout our country. Because of the negative economic and political implications of these shortages, many of the pipeline corporations, with congressional support and encouragement, entered into long-term, very capital-intensive projects including the construction of LNG facilities, coal gasification projects, and new pipeline systems which will deliver gas from the Outer Continental Shelf and Alaska.

As a direct result of this huge capital commitment we have made, which has already done a great deal to provide additional supplies of natural gas, the industry is generating and will continue to generate substantial amounts of investment credit as well as some of the so-called tax preference items, most prominently intangible drilling costs.

In most instances costs for these projects were determined by assuming a certain tax policy that existed prior to 1982. For the Congress to change the ground rules under which our industry has in good faith committed its capital will have a significant negative impact on our industry's ability to commit to new energy projects, and perhaps in some cases to continue with those that have already been started.

Let me give you one example of the future effect the proposed minimum tax will have on at least one of our member companies. This example while not universal is, nevertheless, not atypical within our industry and within our membership.

In 1981 this corporation paid Federal income taxes of $161 million. In 1983, the first year of the proposed minimum tax, the company has estimated that its regular income tax before investment credit will be $86 million. Because of its participation in a coal gasification project as well as other construction activities, it had expected to utilize an investment tax credit of $65 million, leaving a tax payment of $21 million.

A rough computation of this corporation's liability under the proposed minimum tax would produce a tax of $51 million. Perhaps even more significant is the fact that unlike the example given by the Treasury, wherein the alternative tax credit carry forward is used as quickly as in year two, a carry forward of the difference between the regular and the minimum tax for the company in our example, that is, $30 million, could not be utilized in any year through 1986, and the credit would continue to increase year by year to a 1986 total of $132 million. Under the interest rates prevailing today, you can see that the worth of the dollar would not be very great.

We would like to recommend some modifications, Mr. Chairman, and we have in my complete statement some recommendations to make. We would like to suggest a less burdensome and less administratively complex, and a far more evenhanded alternative approach to the proposal that you have from Treasury.

Perhaps a way to do this would be to reduce the investment tax credit income limitation to perhaps 75 percent from the 90 percent that became effective this year. This would increase revenue, but would do so in a less complex manner than in the proposed tax.

We would also like to comment briefly on the repeal of the energy tax credits which we think would be a deterrent to the companies that have relied on these credits to go forward with projects. We think it would be counterproductive, as we think will be the minimum corporate tax.

I do have other items in my statement, Mr. Chairman, and we would like to have that incorporated in the record.

The Chairman. Thank you very much, and the statements will be made a part of the record.

[The prepared statements of the previous panel follow:]

STATEMENT OF WILLIAM E. WALL
CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER OF
THE KANSAS POWER AND LIGHT COMPANY
ON BEHALF OF THE
EDISON ELECTRIC INSTITUTE
BEFORE THE COMMITTEE ON FINANCE

Mr. Chairman and Members of the Committee:

My name is William E. Wall, I am Chairman of the Board and President of the Kansas Power and Light Company. I am pleased to submit this testimony to the Senate Finance Committee as representative of the Edison Electric Institute.

The Edison Electric Institute (EEI) is the association of the nation's investor-owned electric utility companies. EEI member companies provide electric service to 99 percent of all customers of the investor-owned portion of the industry and to more than 77 percent of all users of electricity in the United States.

The electric utility industry is the nation's most capital intensive. It has a construction program approximating $30 billion annually, but it is experiencing major problems in financing its capital investments. This is illustrated by a recent study made by E. F. Hutton which indicates that as many as 25 electric utility companies have had their bond ratings lowered within the past year. A recent study made by Salomon Brothers of 100 electric utilities indicates that the common stock of only six of those companies is selling at greater than book value and that the average market-to-book price ratio is only 81 percent.

We wish to commend this Committee and the Congress for their forward looking actions taken last year in the Economic Recovery Tax Act of 1981 (ERTA) to stimulate capital formation.

Enactment of ERTA was a clear indication that Congress recognized the serious financial plight of many key industries and that aids to capital formation were essential to economic recovery, real growth and increased employment.

EEI has studied the Administration's new proposals for tax revisions and improved collection and enforcement measures. While we are mindful of the magnitude of budget deficits and the need for increased revenues, we must point out that many of the Administration's new tax proposals would directly counter existing capital incentive provisions contained in the Internal Revenue Code, particularly as amended by ERTA. In essence, these proposals represent a new tax on jobs, investment and economic growth. It is with considerable reluctance that we therefore take exception to the following Administration proposals.

I. Alternative Corporate Minimum Tax

Under current law, corporations must pay a minimum tax, in addition to regular income tax, equal to 15% of certain tax preference items. The Administration proposes to repeal the add-on minimum tax effective January 1, 1983, and to replace it with an alternative minimum tax that would require corporations to pay the greater of their regular income tax or an alternative tax equal to 15 percent of their alternative tax base in excess of $50,000. This alternative tax base consists of regular taxable income plus certain tax preferences. Investment tax credits (ITCs) would not be allowed against the alternative minimum tax.

EEI is opposed to the alternative corporate minimum tax in the form proposed by the Administration. The proposed alternative minimum tax would compound the difficulties of many already financially-strapped utilities by imposing a penalty on them in the form of an additional tax liability even though they generally are not substantial users of tax preference items. Even if the amount of minimum tax paid becomes a new credit to be carried over to use against regular tax in later years, the alternative minimum tax would still be a substantial burden to those electric utilities currently in the most precarious financial position.

The practical result of the alternative minimum tax would be to reduce from 90 percent to 67.4 percent the amount by which investment tax credits can be applied against a corporation's regular income tax liability. In effect, the investment tax credit would be turned into a tax preference item instead of an incentive provision, a change that reverses a concept that has been a basic part of our tax law since 1962. This proposal represents a direct reversal of the national policies that led to the enactment of ERTA.

The Institute surveyed its member companies to determine the effect that the alternative minimum tax would have on the electric utility industry. The result clearly indicates that the alternative minimum tax generally would act as a penalty on those companies that are in less healthy financial situations, while not affecting those companies that are in stronger financial positions. To impose an additional tax on companies that already are in financial difficulty is unwarranted. If there is to be a minimum tax, it should apply only to companies that are economically healthy but pay little tax because of the fourteen enumerated tax preferences. For our industry the Administration proposal has created a hidden fifteenth tax preference item - the investment tax credit.

The survey results reveal that a least twenty-seven companies, which produce about 40 percent of the sales of electricity by investor-owned electric utility companies, would incur a liability for the proposed alternative minimum tax, as follows:

Year	Estimated Increase in Tax Liabilities (in millions)	Number of Companies
1983	$ 307	27
1984	348	24
1985	356	23
1986	273	22
	1,284	

It can be reasonably assumed on this basis that the increase in tax liabilities for years 1983-86 for the entire electric utility industry would approximate $2 billion.

The Institute believes that the alternative minimum tax would diminish capital formation incentive and is therefore not supportive of the Administration's proposal in its present form. However, if an alternative minimum tax were adopted, it should be modified to allow utilitization of investment tax credits, including carryover, up to the maximum 90% offset against tax liability, except to the extent that the tax is attributable to the enumerated tax preference items. The impact of the alternative minimum tax would then apply only to those corporations claiming substantial tax preferences.

Similarly, net operating loss carryover to the extent not attributed to utilization of the enumerated tax preference items should be allowed as a reduction of the alternative minimum tax base. Failure to allow this offset would inequitably penalize businesses which suffer short-term economic losses as well as new companies that are not immediately profitable.

The proposed alternative minimum tax would therefore: 1) substantially reduce the existing benefits of investment tax credits to our industry; 2) hit the financially weakest companies the hardest; 3) negatively impact even companies which are not substantive users of preference items; and 4) serve as a disincentive to capital formation and economic growth. The proposal is not simply a "loophole closer". It is a direct reversal of existing tax incentives and represents a new direction in tax policy which is counter to the aims of ERTA.

II. Industrial Development Bonds

The Administration proposes new restrictions on the issuance of tax-exempt bonds for "private purposes". Of particular concern to our industry is the recommendation for an election of either tax-exempt financing or use of the new Accelerated Cost Recovery System (ACRS) enacted in ERTA. The Administration proposes that the costs of depreciable assets financed with an industrial development bond could be recovered only under the straight line depreciation method over periods substantially longer than those used for ACRS purposes.

The investor-owned utility industry generally uses industrial development bonds for three purposes:

1) pollution control facilities;
2) solid waste disposal facilities; and
3) facilities for the local furnishing of electric energy.

We strongly urge that no changes be made that would limit the issuance of these types of bonds or lessen the benefits of their use.

EEI agrees with the Treasury Department that there is a valid distinction between quasi-public and strictly private uses of facilities that are financed with industrial development bonds (IDBs). We believe that the uses enumerated above serve quasi-public functions. Any legislation that limits IDB financing or lessens the benefits of its use should apply only to issues that serve strictly private purposes.

Pollution control bond financing is not only essential but also is fully justified on grounds that do not apply to IDB financing for most other purposes. First, the use of pollution control facilities does not create a profit for any private party, whereas virtually all other facilities financed with IDBs are used for the profit of private parties. Pollution control facilities benefit only the general public, and in an economic sense, they produce for the user of the facility only the burden of increased costs of doing business. Second, pollution control facilities usually are installed because the law requires that they be installed, which is not true of the typical facilities that are financed with IDBs. This has two corollaries. One is that availability of relatively low-cost tax-exempt money does not cause a misdirection of investment. No one uses an investment in pollution control equipment as a tax shelter. The other corollary is that a business that is required by government to make a investment has a better claim on help from the government than the business that makes a discretionary investment. Finally, the future volume of pollution control bond financing will be largely the result of what government does. If pollution control requirements become less burdensome, the use of pollution control bonds will decrease; conversely, if the requirements become more stringent, the need for this form of financing will be even more critical.

Similarly, the local furnishing of electric energy is a quasi-public function. The investor-owned electric utility industry is a regulated industry precisely because the furnishing of electric energy is universally perceived to serve a public purpose, on which the health and safety of our populance depend. We are required by law to provide adequate electric service. Use of IDBs for local furnishing of electric energy is a vital component in our ability to meet this legal requirement to provide adequate, reliable service to our customers at reasonable cost.

Existing restrictions that apply to pollution control and local furnishing bonds already limit their use. Local furnishing is defined as being limited to an area that includes not more than two counties or a city and one contiguous county. This means that very few electric facilities qualify. With respect to pollution control, the

Internal Revenue Service definition of pollution control facilities is quite restrictive; we believe unduly restrictive.

Our industry's uses of IDB financing are in the public interest. Moreover, they are of critical importance in raising capital within our financially distressed industry. The administration's proposed election of either tax-exempt IDB financing or the ACRS system is, in reality, no election at all. In order to utilize IDB financing any facility so financed must be depreciated using a straight line method and a life of 35 years for most utility plant. This is particularly onerous and would effectively stop most future use of these securities for financings, as the benefits of tax-exempt financing are likely to be outweighed by the penalty of straight line depreciation over 35 years.

The Administration further proposes that with respect to bonds issued after December 31, 1985, the government unit issuing the bonds would have to make a financial contribution or commitment to the project being financed with bond proceeds. As a practical matter, we question whether local governments can assume such an obligation, particularly at a time when local government finances are severely pressed for even essential services.

III. Withholding on Interest and Dividends

Current law does not require withholding on the payment of interest and dividends except in case of payments to certain foreign persons. The Administration proposes withholding on dividend and interest payments at a flat 5 percent rate, beginning on January 1, 1983. Exceptions to this proposal include interest payments made to *corporate recipients and certain persons* filing exemption certificates. The Administration estimates that the latter category includes over 70 percent of all elderly persons.

1. It will reduce investors' incentive to invest in the electric utility industry at a time when our industry sorely needs additional capital.
2. It would be a complex and highly expensive plan to administer, particularly in the administration of the exemption program. It would increase the administrative costs of our member companies and prove a burdensome and expensive program.

IV. Accelerated Corporate Income Tax Payments

The Administration proposes that for tax years after 1982, the estimated tax payments will be increased from 80% to 90% of current year liability. The remaining liability is to be paid by the 15th day of the 3rd month following the close of the taxable year in lieu of the present installment election.

This proposal will not increase the taxes our industry pays. It will, however, impose an increased capital requirement on public utilities. The additional financing costs necessary to meet the accelerated deadlines would only add to the industry's financing burden. The Institute therefore does not support this proposal.

V. Business Energy Tax Incentives

Current law provides for a number of nonrefundable energy tax credits for investments in certain business energy property. Among properties eligible for credits are alternative energy property, cogeneration equipment, recycling equipment, solar or wind energy property, ocean thermal equipment, and geothermal equipment and low-head hydroelectric property. Some of these credits are scheduled to expire on December 31, 1982, some on December 31, 1985. The Administration proposes to repeal all of the business energy tax credits not already scheduled to expire on December 31, 1982.

Utility companies are generally prevented from using energy tax credits. However, an electric utility company may enter into a joint venture which is a non-utility business and thus be eligible for the business energy credits. If energy credits are eliminated, the economics of these operations will change, and thus negatively impact our member companies. We believe existing energy tax credits are important incentives to conserve oil and gas and to produce alternative sources of energy. We therefore oppose their repeal.

VI. Construction Period Interest and Taxes

The Administration proposes to amend the Internal Revenue Code to require corporations generally to capitalize and amortize interest and taxes incurred in the construction of non-residential real property.

We believe that the Administration proposal needs to be clarified, particularly in regard to the definition of nonresidential property. If the proposal is adopted, we believe that it should apply only to buildings, as defined in section 1250 of the Internal Revenue Code.

VII. Safe-Harbor Leasing

We are aware that the Administration has not proposed the elimination or substantial revision of the safe-harbor leasing provisions contained in ERTA. We are also aware, however, that a number of proposals have arisen in the Congress to do precisely that, and that, in any event, the safe-harbor leasing provisions will come under serious Congressional scrutiny.

The investor-owned electric utility industry has made use of the safe-harbor leasing provisions, both as lessors and lessees. One major reason for the attractiveness of safe-harbor leasing to our industry is that many companies have substantial amounts of investment tax credits that cannot be used. Many of these companies are therefore interested in safe-harbor leasing as a means to utilize, on a more timely basis, these investment tax credits. Safe-harbor leases have been a valuable source of financing. Repeal or substantial modification of safe-harbor leasing would have a significant negative impact on stimulation of capital formation for our industry, a result again contrary to the intent of ERTA.

We understand that the Congress may wish to review the safe-harbor leasing provisions to correct possible abuses and ensure that no unintended benefits have arisen from the program. In that case, we submit that amending the provision to limit the amount by which a lessor may offset its tax liability would be more appropriate than repeal.

STATEMENT
OF THE
NATIONAL COAL ASSOCIATION

BY

HOWARD H. FREY

VICE CHAIRMAN AND CHIEF ADMINISTRATIVE OFFICER

WESTMORELAND COAL COMPANY

INTRODUCTION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I AM HOWARD H. FREY, VICE CHAIRMAN AND CHIEF ADMINSTRATIVE OFFICER OF THE WESTMORELAND COAL COMPANY OF PHILADELPHIA, PENNSYLVANIA.

TODAY I AM SPEAKING ON BEHALF OF THE NATIONAL COAL ASSOCIATION WHOSE MEMBERS ACCOUNT FOR OVER HALF OF THE UNITED STATES' COAL PRODUCTION. OUR MEMBERS ALSO INCLUDE EQUIPMENT MANUFACTURERS, TRANSPORATION COMPANIES, COAL EXPORTERS, CONSULTANTS, AND OTHER COAL-RELATED INDUSTRIES.

I APPREICATE THIS OPPORTUNITY TO EXPRESS THE COAL INDUSTRY'S VIEWS ON THE ADMINISTRATION'S BUDGET PROPOSAL, SPECIFICALLY SOME TAX RELATED ISSUES AND THEIR EFFECT ON THE COAL INDUSTRY.

***

THE COAL INDUSTRY'S INTEREST IS IN PRESERVING AN ATMOSPHERE OF INVESTMENT INCENTIVE, NECESSARY FOR BUSINESS GROWTH AND DEVELOPMENT, AND CONSISTENT WITH THE PRESIDENT'S ECONOMIC RECOVERY PROGRAM. OUR NATION MUST HAVE AN AMPLE SUPPLY OF REASONABLY PRICED ENERGY TO FUEL ECONOMIC RECOVERY. COAL, AMERICA'S MOST ABUNDANT, MOST VERSATILE, AND LOWEST-PRICED ENERGY RESOURCE WILL PLAY AN INCREASING ROLE IN ACHIEVING THIS GOAL. EXPERTS PREDICT THAT COAL USE IS EXPECTED TO DOUBLE OVER THE NEXT 8 YEARS AND THAT IT WILL BECOME THE UNITED STATES' LEADING EXPORT COMMODITY.

THE NATIONAL COAL ASSOCIATION STILL EXPRESSES ITS SUPPORT FOR PRESIDENT REAGAN'S ECONOMIC RECOVERY PLAN, EVEN THOUGH IT CONTAINS ELEMENTS THAT WOULD ADD TO THE COAL INDUSTRY'S COST OF DOING BUSINESS.

WE WERE UNENTHUSIASTIC, FOR EXAMPLE, ABOUT AN INCREASE IN THE BLACK LUNG TAX IF IT WERE NOT ACCOMPANIED BY A MAJOR REFORM OF THE PROGRAM TO ELIMINATE FLAGRANT ABUSES. NOR ARE WE ENTHRALLED BY THE PROSPECT OF HIGHER CHARGES FOR INLAND WATERWAY TRANSPORTATION IF THEY UNFAIRLY AFFECT THE MOVEMENT OF COAL.

NEVERTHELESS, WE SUPPORTED THE PRESIDENT'S PACKAGE, BELIEVING THAT ULTIMATELY IT'S IN THE NATIONAL INTEREST AS WELL AS THE INTEREST OF THE COAL INDUSTRY.

CAPITAL REQUIREMENTS OF THE COAL INDUSTRY

POLICY STATEMENTS BY THIS AND PREVIOUS ADMINISTRATIONS POSITIONED COAL AS THE MAJOR FUTURE ENERGY RESOURCE FOR OUR COUNTRY. OUR INDUSTRY IS EXPECTED TO DOUBLE PRODUCTION BY 1990 AND TRIPLE PRODUCTION BY THE END OF THE CENTURY. THESE PRODUCTION INCREASES ARE NEEDED TO MEET A GROWING NEED FOR COAL, BOTH HERE AND ABROAD, AS THE WORLD'S FREE NATIONS SEEK TO REDUCE THEIR DEPENDENCE ON OPEC OIL.

THESE GOALS ARE REASONABLE, AND THEY CAN BE MET--PROVIDED THE MEANS ARE AVAILABLE TO FINANCE THE VERY SUBSTANTIAL INVESTMENT IN MACHINERY AND EQUIPMENT THAT WILL BE REQUIRED.

THE U.S. COAL INDUSTRY TODAY MUST ADDRESS THE REALITIES OF "CONSTRAINED ABUNDANCE." WE CAN PRODUCE 100 MILLION TONS MORE COAL ANNUALLY THAN THE MARKET IS TAKING. BUT WE ARE CONFIDENT THIS IS A TEMPORARY CONDITION AND WILL CHANGE AS MORE COAL IS USED IN OUR OWN COUNTRY AND OVERSEAS.

BY CONSERVATIVE ESTIMATES, THE COAL INDUSTRY WILL REQUIRE MORE THAN THREE TIMES OUR PRESENT CAPITALIZATION -- AT LEAST $50 BILLION FOR CAPITAL INVESTMENT BETWEEN NOW AND 1990 -- AND MORE THAN TWICE THAT AMOUNT BY THE YEAR 2000.

NEW COAL MINES TO MEET FUTURE DEMAND FOR OUR COUNTRY'S MOST ABUNDANT ENERGY RESOURCE WILL PROVIDE TENS OF THOUSANDS OF JOBS, BOTH DIRECTLY IN THE COAL PRODUCING INDUSTRY AND INDIRECTLY IN SUPPORTING INDUSTRIES SUCH AS EQUIPMENT MANUFACTURING, TRANSPORTATION AND SALES.

BUT THOSE JOBS AND ALL THE SPIN-OFF ECONOMIC BENEFITS WILL NOT BE REALIZED UNLESS COAL PRODUCERS CAN MEET RAPIDLY ESCALATING CAPITAL COSTS.

FIRST WE NEED A FRAME OF REFERENCE OF THE MAGNITUDE OF CAPITAL INVESTMENT REQUIRED. IT IS GENERALLY ACCEPTED THAT THE COST OF A NEW UNDERGROUND MINE -- EXCLUSIVE OF THE COST OF THE COAL ITSELF -- IS MORE THAN $55 PER TON OF ANNUAL PRODUCTION. THIS DOES NOT INCLUDE THE SUBSTANTIAL ADMINISTRATIVE COSTS BEFORE START-UP. THIS INCLUDES SURVEYS, FEASIBILITY STUDIES AND OTHER SUCH COSTS. THUS, A MEDIUM-SIZE MINE WITH A CAPACITY OF ONE MILLION TONS A YEAR REPRESENTS A CAPITAL INVESTMENT OF WELL OVER $55 MILLION BEFORE ONE TON OF COAL IS PRODUCED. OVER THE LAST TEN YEARS PRODUCTION COSTS IN THE COAL INDUSTRY HAVE RISEN BY 100 PERCENT.

GIVEN THESE REALITIES, THE COAL INDUSTRY IS DEEPLY CONCERNED ABOUT SEVERAL ASPECTS OF THE REAGAN ADMINISTRATION'S PROPOSED REVISIONS OF TAX LAW AND THEIR EFFECTS. WE BELIEVE THESE REVISIONS WILL BE DAMAGING TO THE COAL INDUSTRY, AND COUNTER PRODUCTIVE TO THE ADMINISTRATION'S GOAL OF REVIVING OUR COUNTRY'S SAGGING ECONOMY.

THE ALTERNATIVE MINIMUM TAX

MR. CHAIRMAN, THE COAL INDUSTRY IS FACING LARGE INCREASES IN PRODUCTION COSTS AND DECLINING PROFIT MARGINS AT THE VERY TIME WHEN WE MUST PLAN INDUSTRY EXPANSION. THE HIGHEST DEGREE OF INVESTMENT INCENTIVE POSSIBLE IS A NECESSITY.

FOR THESE REASONS WE URGE THE REPEAL OF THE PRESENT CORPORATE MINIMUM TAX WHICH IS BEING PROPOSED. BOTH TAXES, WE BELIEVE ARE CONTRARY TO THE GOALS OF SOUND ECONOMIC GROWTH, BUT ALSO WORK A SPECIAL HARDSHIP ON LOW-PROFIT, CAPITAL-INTENSIVE INDUSTRIES, SUCH AS COAL.

THE MINIMUM TAX CONCEPT, FOR EXAMPLE, DILUTES THE TAX INCENTIVES INTENDED TO HELP SPUR NEW INVESTMENT, WHICH IS CENTRAL TO THE ECONOMIC RECOVERY TAX ACT OF 1981. MINING IS THEORETICALLY GRANTED A TEN PERCENT DEPLETION ALLOWANCE, BUT FEW COAL PRODUCERS CAN TAKE FULL ADVANTAGE OF THE INCENTIVES OFFERED BECAUSE OF THE 50 PERCENT OF NET INCOME LIMITATION. FROM 1975 TO 1980, OUR STUDIES SHOW THAT THE COAL INDUSTRY'S EFFECTIVE DEPLETION RATE DROPPED FROM JUST OVER SEVEN PERCENT TO JUST UNDER FIVE PERCENT, ILLUSTRATING THE INDUSTRY'S DECLINING PROFIT MARGINS.

BY ADDING MINING EXPLORATION AND DEVELOPMENT COSTS AS A PREFERENCE ITEM, MANY COAL COMPANIES AND OTHER MINING INTERESTS WILL BE FURTHER STARVED FOR CAPITAL INVESTMENT.

TREASURY SECRETARY REGAN HAS STATED THAT MANY CORPORATIONS PAY LITTLE OR NO FEDERAL INCOME TAX, DESPITE REPORTING LARGE PROFITS TO THEIR SHAREHOLDERS. IN THE TREASURY DEPARTMENT'S VIEW, THIS TAX WOULD APPLY TO "CORPORATE PROFITS," THAT IS, REGULAR TAXABLE INCOME PLUS SELECTED INCENTIVES, AND WOULD APPLY ONLY TO THOSE CORPORATIONS THAT PAY VERY LOW REGULAR RATES OF TAX.

THAT MAY BE SO, BUT IT WOULD IMPACT GREATEST ON LOW PROFIT, CAPITAL INTENSIVE INDUSTRIES INCLUDING THOSE MINING COAL.

The existing add-on minimum tax is in itself onerous in that it substantially detracts from whatever benefits percentage depletion may allow. In the capital intensive mining industry, where capital outlays are mandatory in order to obtain the level of productivity that the country requires for its fuel economic recovery, the add-on minimum tax substantially impedes the ability of such medium-sized mining companies as Westmoreland to develop their resources. The proposed alternative minimum tax would be even more detrimental in that it is proposed that mining exploration and development costs would be includable in the corporate minimum tax base for the deductions in excess of the amortization that would have been allowed on the straight-line basis over ten years. Mining exploration and development costs represent capital expenditures from which no benefit will be derived perhaps for years on end. Most mining companies, operating on a low profit basis anyway, do deduct these costs as incurred. To treat these necessary expenditures as items of preference does not give cognizance to the realities of the problems confronting purely mining companies. As a case in point, for the years 1976 through 1981, Westmoreland and its operating subsidiaries incurred exploration and development costs amounting to over $47 million. Had these costs been subject to minimum tax, the Company would have been required to pay out an additional $7 million in federal income tax. The argument that the deduction of exploration and development costs as incurred is tax preferential is specious. Whether deducted in the year incurred or amortized over the ten year period proposed, ultimately the corporation will recognize the same amount of deductions. Congress recently liberalized the tax depreciation rules by creating the ACR System, in order to create the opportunity to enhance capital investment. No thought has been given to including accelerated ACRS depreciation over straight-line on personal property as a tax preference item. To impose this penalty on purely mining companies, which traditionally, and especially within the last five years, have had low or no profits whatsoever, flies in the face of equity. If accelerated depreciation on personal property is not subject to minimum tax, it is absurd to impose this burden on an industry which certainly does not have the wherewithal to bear such a burden. The mining industry is not deriving an unfair advantage over other industries, but desperately needs these incentives in order to obtain the capital that it requires.

I SAY AGAIN, THE ADD-ON CORPORATE MINIMUM TAX SHOULD BE REPEALED RATHER THAN BE MADE MORE ONEROUS BY SUBSTITUTING THE PROPOSED ALTERNATIVE MINIMUM TAX.

SAFE HARBOR LEASING

ANOTHER PROPOSAL, THE REPEAL OF SECTION 168 (F)(8) -- THE SO-CALLED "SAFE HARBORS" LEASING PROVISION -- WOULD RENDER IMPOTENT THE INCENTIVES PACKAGE OF THE ECONOMIC RECOVERY TAX ACT OF 1981 FOR MANY COMPANIES IN THE MINING INDUSTRY.

THE COAL INDUSTRY BELIEVES THAT SECTION 168 (F)(8) MAKES THE ECONOMIC INCENTIVES OF THE TAX ACT AVAILABLE EQUALLY TO ALL COMPANIES, PERMITTING INVESTMENT STRATEGIES BASED ON POTENTIAL PROFITABILITY AND NOT ON EXISTING TAX CIRCUMSTANCES. WITHOUT SUCH A PROVISION, IDENTICAL INVESTMENTS CAN HAVE FAR DIFFERING RETURNS BASED ON PROFITABILITY FROM OLDER ASSETS AND OTHER CIRCUMSTANCES HAVING LITTLE TO DO WITH THE PARTICULAR INVESTMENT.

IF THE "SAFE HARBORS" LEASING PROVISION IS REPEALED, THE OTHER INCENTIVES IN THE TAX ACT COULD LEAD TO UNEVEN DEVELOPMENT ACTIVITIY IN THE ECONOMY AND ENCOURAGE MERGERS WHICH SERVE NO OTHER ECONOMIC PURPOSE EXCEPT TAX ADVANTAGE. IN ESSENCE, THE TAX ACT WOULD THEN BE STRONGLY BIASED TOWARD CERTAIN SEGMENTS AND CERTAIN CLASSES OF COMPANIES -- AT THE EXPENSE OF INCREASED COMPETITION AND BROAD-BASED GROWTH.

SIMPLY PUT, THE COAL INDUSTRY SUPPORTS THE RETENTION OF THE "SAFE HARBORS" LEASING PROVISION BECAUSE IT WILL STIMULATE INVESTMENT IN NEW MINES AND OTHER FACILITIES.

LAST YEAR THE ACCELERATED COST RECOVERY SYSTEM BECAME LAW. THAT COUPLED WITH THE INVESTMENT TAX CREDIT PROVIDES AN ADDED INCENTIVE FOR COMPANIES TO INVEST IN PRODUCTIVE MACHINERY AND EQUIPMENT. HOWEVER, FOR CERTAIN TAXPAYERS THE DESIRE MAY EXIST, BUT A LACK OF CAPITAL PRECLUDES THE EXPANSION AND MODERNIZATION OF PRODUCTIVE FACILITIES. THIS IS PARTICULARLY TRUE FOR THE CAPITAL INTENSIVE, LOW PROFIT INDUSTRIES, SUCH AS COAL MINING.

I UNDERSTAND THE LOGIC BEHIND THE MOVE TO REPEAL THIS PROVISION -- THAT LEASING IS A SUBSIDY FOR THE INEFFICIENT. BUT WE DON'T AGREE WTH THE ASSUMPTION.

I SIMPLY WANT TO POINT OUT THAT SOME COMPANIES ARE PAYING LOW TAX RATES -- NOT BECAUSE THEY HAVE LOW TAXABLE INCOME -- BUT BECAUSE THEY HAVE LOW PROFIT MARGINS, WHICH IS WHOLLY CONSISTENT WITH REASONABLE TAX POLICY.

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VERY BRIEFLY, LET ME COMMENT ON THREE OTHER PROPOSALS BEFORE THIS COMMITTEE: BUSINESS ENERGY TAX CREDITS, TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS, AND THE ACCLERATION OF CORPORATE TAX PAYMENTS.

BUSINESS ENERGY CREDITS ARE NEEDED BECAUSE THEY OFFER ENERGY CONSUMERS AN INCENTIVE TO WEIGH THE BENEFITS OF CONVERTING FROM OIL AND NATURAL GAS TO COAL. WE BELIEVE CONVERSION TO COAL IS CLEARLY IN THE NATIONAL INTEREST FOR THE REASONS I STATED EARLIER IN MY TESTIMONY.

INDUSTRIAL DEVELOPMENT BONDS ARE CRUCIAL TO HELP ELECTRIC UTILITIES MEET LEGAL REQUIREMENTS OF RETROFITTING THEIR PLANTS WITH NEW POLLUTION CONTROL EQUIPMENT AT A SAVINGS TO THE COMPANIES AND TO CONSUMERS.

WE BELIEVE THAT IDB'S ARE WHOLLY CONSISTENT WITH THE PRESIDENT'S GOALS OF ENERGY DEVELOPMENT AND ENVIRONMENTAL PROTECTION AT THE LOWEST FEASIBLE COSTS TO ALL CONSUMERS.

THE COAL INDUSTRY DOESN'T SUPPORT THE ACCELERATION OF TAX PAYMENTS. BY [illegible] CURRENT LAW WILL REQUIRE THAT CORPORATIONS PAY CURRENTLY 80 PERCENT OF THEIR TAX LIABILITY. DUE TO UNCERTAINTIES, ESTIMATING TAXABLE INCOME OR THE FACT THAT TAXABLE INCOME REFLECTS RECEIVABLES FROM CUSTOMERS, ANY FURTHER ACCELERATION OF TAX PAYMENTS WILL RESULT IN ADDITIONAL COSTS AND INFINITE ADMINISTRATIVE BURDENS.

IN CONCLUSION, MR. CHAIRMAN, LET ME QUOTE PETER DRUCKER, THE WELL-KNOWN MANAGEMENT EXPERT: "LONG RANGE PLANNING," HE SAID, "DOESN'T DEAL WITH FUTURE DECISIONS, BUT WITH THE FUTURE OF PRESENT DECISIONS."

IT TAKES AS MUCH AS A DECADE TO BRING A NEW DEEP MINE INTO COMMERCIAL PRODUCTION. THESE FUTURE ENERGY REALITIES DEPEND ON TODAY'S INVESTMENT DECISIONS. BUT IT'S DIFFICULT, IF NOT IMPOSSIBLE, TO MAKE A WISE, SOUND INVESTMENT AND ENERGY DECISION UNLESS THERE IS CONSISTENT ECONOMIC AND TAX POLICY. ONE OF THE MOST PRESSING GOALS IS TO RESTORE STABILITY TO OUR ECONOMY AND INSTILL MORE CONFIDENCE IN INVESTMENT DECISIONS.

WE BELIEVE THE ECONOMIC RECOVERY TAX ACT OF 1981 IS THE BASIS FOR SUCH A STEADY, SOUND COURSE. IT IS DESIGNED IN PART TO SPUR INDUSTRIAL EXPANSION AND TO MODERNIZE WHAT WE ARE USING. SPECIFIC PROVISIONS OF THE ACT ARE TARGETED TO TOUCH CAPITAL INTENSIVE, LOW-PROFIT INDUSTRIES, SUCH AS COAL.

THE COAL INDUSTRY DOESN'T BELIEVE THE ADMINISTRATION'S PROPOSALS ARE CONSISTENT WITH A STEADY COURSE. IN SOME INSTANCES THESE CHANGES WOULD LEAVE INDUSTRY IN A WORSE INVESTMENT AND PLANNING CONDITION THAN BEFORE THE ACT WAS PASSED.

WE URGE THAT THE ACT BE GIVEN MORE TIME TO WORK ITS COURSE.

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J. ALLEN OVERTON JR.
PRESIDENT

STATEMENT
OF THE
AMERICAN MINING CONGRESS
TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
BY
DENNIS P. BEDELL
CHAIRMAN, AMERICAN MINING CONGRESS TAX COMMITTEE
MARCH 18, 1982

Mr. Chairman and Members of the Committee:

My name is Dennis P. Bedell. I am Chairman of the Tax Committee of the American Mining Congress and a member of the Washington, D. C. law firm of Miller & Chevalier, Chartered.

I am appearing before you today on behalf of the American Mining Congress. We appreciate this opportunity to testify with regard to the tax proposals made by the Administration in its budget recommendations for fiscal year 1983.

The American Mining Congress is an industry association representing all segments of the mining industry. It is composed of (1) U. S. companies that produce most of the nation's metals, coal and industrial and agricultural minerals; (2) companies that manufacture mining and mineral processing machinery, equipment and supplies; and (3) engineering and consulting firms and financial institutions that serve the mining industry.

The American Mining Congress strongly opposes the Administration's proposals to repeal for all practical purposes a substantial part of the business tax reductions that were embodied in the Economic Recovery Tax Act of 1981. In the aggregate, the fiscal 1983 budget indicates that the Administration proposes to take from the corporate sector during the period of 1982 through 1985 approximately 50 percent of the corporate benefits enacted in the 1981 tax changes.

In particular, the American Mining Congress is most concerned with the Administration's proposal for a corporate alternative minimum tax and its proposal with respect to tax exempt industrial development bonds.

Corporate Minimum Tax

The Administration's proposal for a corporate minimum tax, which would fall most heavily on those businesses making needed capital investments, is a complete about-face from its proposals of last year. By the corporate minimum tax proposal, the Administration will penalize capital investment and thus create an unfavorable climate for needed capital formation.

The proposal reverses the thrust of the Economic Recovery Tax Act and it cannot but hurt the prospects for recovery from the recession presently being experienced by this country.

It is important to note that stability of investment climate is an extremely important factor in allowing needed investment decisions and programs to be undertaken. The Administration, however, by its tax proposals has created a climate of instability. Last year it argued strenuously for enactment of tax provisions to stimulate capital investment--the ACRS system and investment tax credit improvements. This year it proposes to significantly take back those tax benefits and to penalize the making of capital investments. This flip-flop in tax policy is most disruptive to sound investment decisions.

The serious impact of the corporate minimum tax proposal on capital investment is illustrated by the fact that it will significantly increase the tax liability of a corporate taxpayer which has absolutely no "tax preferences" but which, because it is in a capital intensive industry and made needed capital investments, has substantial investment tax credits. In effect, under the Administration's proposal the present 90 percent of tax liability limitation on the use of investment credits would be reduced by more than a quarter to approximately 67 percent. In other words, the practical effect of the Administration's proposal is the deferral of the use of a substantial portion of investment tax credits. Where an industry is in a depressed profit position and the length of this deferral extends to a number of years, it then becomes equivalent to the repeal of a significant portion of the investment credit.

Not only is the Administration's corporate minimum tax proposal unwise generally from the standpoint of the need to stimulate capital investment, it is particularly inequitable in its impact on the mining industry. There is no question that mining is one of the most capital intensive of all industries. Indeed, in recent years the mining industry's capital needs have been significantly increased by reason of factors such as environmental, health and safety, and other government-mandated expenditures as well as the high costs of debt, rapidly escalating costs resulting from inflation, rising energy costs, and low profitability in the case of a number of our major mineral sectors. Although the mining industry did not anticipate that it would receive direct or immediate tax benefit from the ACRS and investment tax credit proposals of the Administration last year, because of the cyclical depressed profit situation of the industry, the mining industry nevertheless strongly supported the Administration's proposals. The mining industry believes those proposals--which were enacted as part of the 1981 Economic Recovery Tax Act--will stimulate investment and improve productivity growth rates and, thus, will improve economic conditions generally. That general improvement in economic conditions in the long run will benefit the mining industry.

For these reasons, the mining industry supported the business tax provisions proposed by the Administration in 1981 even though, except for the safe harbor leasing provisions, they were of little direct benefit to the industry. The Administration's present corporate minimum tax proposal, however, will have a major detrimental impact on the mining industry. A survey of a number of member companies of the American Mining Congress indicates that the Administration's proposed corporate minimum tax could increase their total federal tax liabilities by more than $100 million per year. The actual impact on the mining industry would be even greater than this since this estimate does not include the mining operations of iron and steel companies.

Thus, in the case of the mining industry, the Administration's corporate minimum tax proposal in many cases will negate the benefits derived from the Economic Recovery Tax Act of 1981 and in other cases will place companies in even a worse tax position than if the 1981 Act had never been enacted.

The Administration's proposal thus will not only adversely affect the ability of the mining industry to make needed capital investments but it also will adversely impact the exploration for and development of domestic sources for strategic minerals. The dependence on foreign sources for a number of strategic minerals is already a serious problem, as is illustrated by the Bureau of Mines charts which are included as Appendix A.

In addition to these economic and business investment considerations, it should be noted that the Administration's corporate minimum tax proposal also is unsound tax policy. It would impose a tax on the very businesses which make the investments and take the actions that the investment tax credit, the ACRS system and other specified tax provisions were enacted to encourage. Thus, those businesses which make investments in new plant and equipment could, solely by virtue of the tax benefits accorded those investments, become subject to the minimum tax. Moreover, the impact of the proposed corporate minimum tax is greatest when a business is in a depressed profit position--a most illogical result.

Safe Harbor Leasing

The American Mining Congress also is quite concerned with the suggestions that have been made to eliminate the safe harbor leasing provisions enacted last year. We strongly support the continuation of those provisions, although we recognize that changes may have to be made to deal with perceived abuses. The safe harbor leasing provisions are needed for the following reasons:

1. Investment incentives.--The leasing provisions are necessary to extend the ACRS and investment tax credit investment incentives to all businesses, regardless of their tax posture. This is particularly relevant for those major capital intensive industrial segments that are presently in a depressed profit position such as the automobile, steel, mining, airline, railroad, and paper products industries. Without safe harbor leasing, the intended incentives for investment in new productive facilities--the investment tax credits and the ACRS deductions--would not be available to these sectors.

2. Tax neutrality.--Tax policy should be neutral to the maximum extent possible as between companies making essentially identical capital expenditures. Safe harbor leasing provides the desired tax neutrality and, thus, allows the marketplace to allocate capital investment to the most efficient uses. Safe harbor leasing will not change a bad investment in new equipment into a good one. No lessor will provide funds for an investment that is not economically viable. In this regard, safe harbor leasing is essentially no different from traditional equipment leasing which has long been used as

a financing tool. Thus, it is not proper to say that safe harbor leasing subsidizes inefficient "loser" companies.

3. Funds for investment.--The safe harbor leasing provisions provide safe harbor lessees--the users--with funds that enable them to make capital expenditures that otherwise would have been postponed or perhaps not made at all. Thus, these provisions allow the mining industry to make the capital investments needed to expand, modernize, and revitalize as intended by the 1981 Act.

4. Most benefits are passed through to the lessee-users of equipment.--The effect of the safe harbor leasing provisions is to provide lessee-users with total benefits (the initial cash payment plus the tax benefit of rental deductions) that approximate the tax benefits associated with ownership of the property. Moreover, as the marketplace has become more experienced with the safe harbor leasing provisions, the trend has been to higher initial cash payments and thus greater benefits to the lessee-user-investor in new productive facilities.

5. Leasing deters tax-motivated takeovers and mergers.--In the absence of safe harbor leasing that permits them to utilize cost recovery deductions and investment tax credits, many depressed profit companies would accumulate net operating loss carryovers and investment tax credit carryovers, thereby making them more attractive takeover targets. The economic concentration resulting from such takeovers could have an adverse impact on competition.

The American Mining Congress recognizes that Congress may wish to review the law to see if unintended benefits have been derived from the provisions. Indeed, it might be appropriate to impose a cap or overall limit on the amount to which a lessor may reduce tax liabilities. Of course, a cap or tax liability limit such as this could be done directly without resorting to an alternative minimum tax machine under which a lessor's safe harbor leasing benefits are taxed as an item of tax preference.

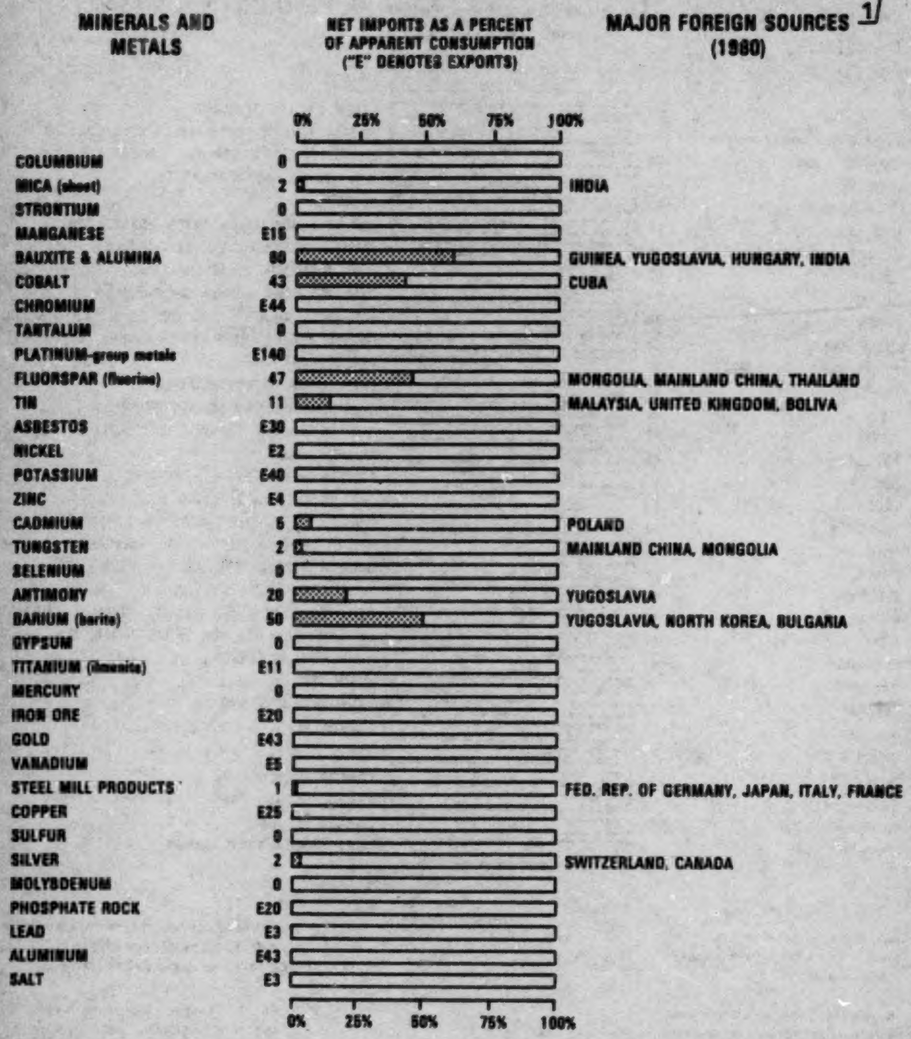
IDB Financing of Pollution Control Facilities

The mining industry has been faced with increasingly heavy capital expenditures to meet the many new environmental requirements imposed on it. Moreover, in future years the mining industry will be required to spend large amounts of capital for pollution control facilities and other government-mandated expenditures. Industrial revenue bond finance for pollution control facilities provides some easing of the financial burden on the industry of meeting pollution control standards.

Accordingly, the American Mining Congress opposes the restrictions proposed by the Administration to the extent industrial development bond financing for pollution control facilities would be significantly impaired.

APPENDIX A

U.S.S.R. NET IMPORT RELIANCE OF SELECTED MINERALS AND METALS AS A PERCENT OF CONSUMPTION IN 1980



1/ SOURCES SHOWN ARE POINTS OF SHIPMENT TO THE U.S.S.R. AND ARE NOT NECESSARILY THE INITIAL SOURCES OF THE MATERIAL.

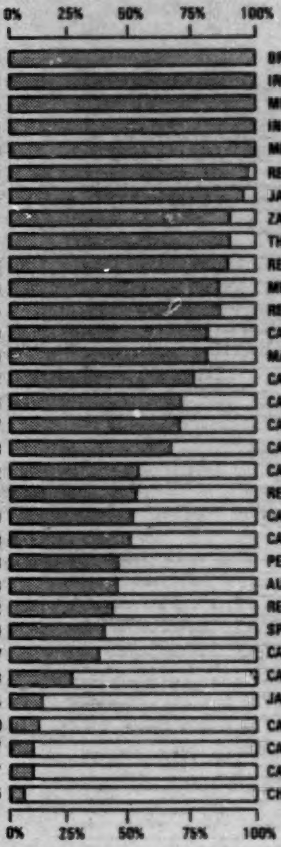
*NET IMPORTS = IMPORTS - EXPORTS

**APPARENT CONSUMPTION = DOMESTIC MINE OUTPUT + NET IMPORTS

FEBRUARY 1982

BUREAU OF MINES, U.S. DEPARTMENT OF THE INTERIOR

U.S. NET IMPORT RELIANCE OF SELECTED MINERALS AND METALS AS A PERCENT OF CONSUMPTION IN 1981 1/



MINERALS AND METALS 2/	NET IMPORT RELIANCE* AS A PERCENT OF APPARENT CONSUMPTION**	MAJOR FOREIGN SOURCES 3/ (1977-1980)
COLUMBIUM	100	BRAZIL, CANADA, THAILAND
DIAMOND (industrial stones)	100	IRELAND, REP. OF SOUTH AFRICA, BELG.-LUX., U.K.
GRAPHITE (natural)	100	MEXICO, REP. OF KOREA, MADAGASCAR, U.S.S.R.
MICA (sheet)	100	INDIA, BRAZIL, MADAGASCAR
STRONTIUM	100	MEXICO
MANGANESE	98	REP. OF SOUTH AFRICA, GABON, FRANCE, BRAZIL
BAUXITE & ALUMINA	94	JAMAICA, AUSTRALIA, GUINEA, SURINAME
COBALT	91	ZAIRE, BELG.-LUX., ZAMBIA, FINLAND
TANTALUM	91	THAILAND, CANADA, MALAYSIA, BRAZIL
CHROMIUM	90	REP. OF SOUTH AFRICA, PHILIPPINES, U.S.S.R., FINLAND
FLUORSPAR	85	MEXICO, REP. OF SOUTH AFRICA, SPAIN, ITALY
PLATINUM—GROUP METALS	85	REP. OF SOUTH AFRICA, U.S.S.R., U.K.
ASBESTOS	80	CANADA, REP. OF SOUTH AFRICA
TIN	80	MALAYSIA, THAILAND, BOLIVIA, INDONESIA
NICKEL	72	CANADA, NORWAY, BOTSWANA, AUSTRALIA
POTASH	68	CANADA, ISRAEL
ZINC	67	CANADA, MEXICO, SPAIN, AUSTRALIA
CADMIUM	63	CANADA, AUSTRALIA, MEXICO, BELG.-LUX.
TUNGSTEN	52	CANADA, BOLIVIA, MAINLAND CHINA, THAILAND
ANTIMONY	51	REP. OF SOUTH AFRICA, BOLIVIA, MAINLAND CHINA, MEXICO
SILVER	50	CANADA, MEXICO, PERU, U.K.
SELENIUM	49	CANADA, JAPAN, YUGOSLAVIA
BARIUM	43	PERU, MAINLAND CHINA, IRELAND, MOROCCO, CHILE
TITANIUM (ilmenite)	43	AUSTRALIA, CANADA, REP. OF SOUTH AFRICA
VANADIUM	42	REP. OF SOUTH AFRICA, CHILE, CANADA
MERCURY	39	SPAIN, ALGERIA, JAPAN, ITALY
GYPSUM	37	CANADA, MEXICO, JAMAICA
IRON ORE	28	CANADA, VENEZUELA, BRAZIL, LIBERIA
IRON & STEEL	14	JAPAN, EUROPE, CANADA
LEAD	10	CANADA, MEXICO, PERU
GOLD	7	CANADA, U.S.S.R., SWITZERLAND
SULFUR	7	CANADA, MEXICO
COPPER	5	CHILE, CANADA, PERU, ZAMBIA

*NET IMPORT RELIANCE = IMPORTS-EXPORTS +ADJUSTMENTS FOR GOV'T AND INDUSTRY STOCK CHANGES.

**APPARENT CONSUMPTION = U.S. PRIMARY +SECONDARY PRODUCTION + NET IMPORT RELIANCE.

1/ JANUARY 28, 1982 (ESTIMATE).

2/ SUBSTANTIAL QUANTITIES ARE IMPORTED FOR RUTILE, RHENIUM AND ZIRCON. DATA WITHHELD TO AVOID DISCLOSING COMPANY PROPRIETARY DATA.

3/ SOURCES SHOWN ARE POINTS OF SHIPMENT TO THE U.S. AND ARE NOT NECESSARILY THE INITIAL SOURCES OF THE MATERIAL.

BUREAU OF MINES, U.S. DEPARTMENT OF THE INTERIOR
(import-export data from Bureau of the Census)

STATEMENT OF
JEROME J. MC GRATH, PRESIDENT
INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA
BEFORE
THE COMMITTEE ON FINANCE
OF THE
U. S. SENATE

March 18, 1982

I am Jerome J. McGrath, President of the Interstate Natural Gas Association of America (INGAA). INGAA is a non-profit national trade association whose membership consists of virtually all of the major interstate natural gas transmission companies in the United States. INGAA's members account for approximately 90 percent of the natural gas that is transported and sold in interstate commerce.

Natural gas constitutes approximately one-fourth of the total energy consumed by our economy. The features of safety, cleanliness, and reliability make gas a desired fuel. In addition, when burned, gas releases virtually no pollutants and, thus, poses no environmental threat. Ninety-six percent of the gas consumed in this country is produced domestically and, therefore, is invulnerable to foreign embargo. Gas supplies about 40 percent of the total energy requirement of the U. S. industrial sector. As you can see, gas has occupied an essential role in our society. We feel confident that gas can continue to maintain its important place in our energy picture. To do this, however, it is essential that the tax treatment accorded our industry be such as to encourage rather than to discourage the substantial investments needed to meet this challenge.

I am appearing before the Finance Committee to discuss three provisions of the Administration's Tax Revisions and Improved Collection and Enforcement Proposals. They are: the new corporation minimum tax, repeal of the energy tax credit and the proposal to require corporations to pay 90 percent of their estimated tax liability.

Before commenting on the proposed corporation minimum tax, I would like first to make two basic points. One, INGAA recognizes the real political and economic problems faced by Congress in attempting to reduce the anticipated budget deficits. Two, the natural gas pipeline industry has been and will continue to be a substantial taxpayer for many years.

INGAA is, however, opposed to enactment of a minimum corporation tax because we believe that such legislation will deter or discourage efforts by our industry to make this nation more energy self-sufficient. To the extent the alternative tax is a response to the revenue implications and industry patterned tax benefits produced by ERTA, we believe it would be better to specifically scrutinize ERTA's impacts and to squarely address any structural defects that may be identified.

Just a very few years ago, energy shortages were an all too common occurrence throughout our nation. Because of the negative economic and political implications of these shortages, many of the pipeline corporations with Congressional support and encouragement, entered into long-term, very capital intensive projects including the construction of LNG facilities, coal gasification projects and new pipeline systems which will deliver gas from the Outer Continental Shelf and Alaska. Many of these same corporations have also developed large exploration and development programs to augment gas reserves.

As a direct result of this huge capital commitment, which has already done a great deal to provide additional supplies of natural gas, the industry is generating and will continue to generate, substantial amounts of investment credit as well as to include some of the so-called "tax preference" items, most prominently, intangible drilling costs. This industry was directly encouraged by the Federal government over several Administrations and during several Congresses, to pursue these ventures and was indirectly urged to allocate its capital in certain ways through the tax code by means of these credits and preferences.

In most instances, costs were determined by assuming a certain tax policy that existed prior to 1982. For the Congress to change the "ground rules" under which our industry has in good faith committed its capital, will have a significant negative impact on our industry's ability to commit to new energy projects and perhaps, in some cases, to continue with those that have already begun. For some of our members, the alternative tax will amount to a tax on the investment tax credit, thus reducing its economic value. Such a tax on the investment credit may not be, probably will not be borne by other of our member companies. Thus, some will receive the full benefit of the investment tax credit and some will not. This raises a very serious issue as to what the investment credit is intended to do and how it is to be utilized by the business community.

Allow me to cite one example of the future effect the proposed minimum tax will have on one of INGAA's members. I am told that this example, while not universal, is nevertheless not atypical with our membership.

In 1981, this corporation paid Federal income taxes of $161,000,000 which is a sizeable sum for corporations the size of many of INGAA's members. In 1983, the first year of the proposed minimum tax, the company has estimated that its regular income tax before investment credit will be $86,000,000. Because of this company's participation in a coal gasification project, as well as other construction activities, it had expected to utilize an investment tax credit of $65,000,000 leaving a tax payment of $21,000,000. A rough computation of this corporation's liability under the proposed minimum tax would produce a tax of $51,000,000.

Perhaps even more significant is the fact that unlike the example given by the Treasury wherein the alternative tax credit is used as quickly as in year two, a carry forward of the difference between the regular and the minimum tax for the company in our example, i.e., $30,000,000, could not be utilized in any year through 1986, and the credit would continue to increase year by year to a 1986 total of $132,000,000. (The corporation has no estimate of tax beyond 1986.) Under the interest rates prevailing today, the present worth of a dollar that cannot be utilized for several years would indeed be small and hardly the kind of incentive to meet the nation's growing energy needs. More generally, such a pattern amounts to a permanent diminution in the value of the investment tax credit as a direct result of the alternative minimum tax.

Earlier in my statement, I mentioned the fact that growing budget deficits must be dealt with, and members of Congress have a most difficult problem on their hands in the budget area.

Mr. Chairman, INGAA recognizes this problem and will be pleased to work with the Committee to find less complex, administratively burdensome and potentially harmful methods to reduce budgetary pressures. For example, a simple and far more even-handed alternative approach to the proposal before you would be to reduce the investment tax credit income limitation to perhaps 75 percent from the 90 percent that became effective this year. This would increase revenue but would do so in a less complex manner than the new proposed tax.

If, however, Congress decides to pursue the enactment of a minimum tax in some form, then INGAA proposes the following be considered:

1. Corporations should be permitted to utilize up to 50 percent of their available tax credits for the year in arriving at their minimum tax liability. The balance of the available credits would be carried forward for use in subsequent years.
2. The proposal regarding intangible drilling costs should be clarified so that the proposed ten year amortization offset should not be applied on a well-by-well basis. Instead, the offset should be utilized against IDC on other wells drilled by the taxpayer because there will be little if any IDC

after production has started or where the well is abandoned in a subsequent year before your costs have been recovered. We believe that all IDC on producing wells should be amortized in full over the 120-month period when computing the minimum tax.

3. That corporations be allowed a new annual election as to whether they wish to deduct intangible drilling cost currently or amortize these costs over a 60-month period.

If the purpose of the minimum tax is to tax economic profits, it is hard to understand why a tax is being imposed upon drilling expenditures before it is known whether these costs will be recovered with a profit.

Mr. Chairman, the second proposal I would like to discuss briefly is the repeal of the energy tax credit. As I mentioned previously, a number of our member companies have in complete good faith and with serious intent started long-term energy projects in reliance upon receiving the energy credit. Others have committed many millions of dollars in engineering studies and costs preparatory to commencement of projects but have not yet reached the contracting stage. It is extremely doubtful that these projects can be financed and contructed absent the energy credit. Without the credits, long-term energy projects will not get off the ground and are of such a magnitude that, even if some future Congress sees fit to reinstate the credits, energy from these sources will be delayed for many, many years. In considering its position on the energy credits, the Committee should recognize it is being asked to revisit fundamental issues of energy policy and objectives;

issues just recently settled by Congress after prolonged debate. If Congress does repeal the credit, it should be clarified that taxpayers who have and can establish they have committed more than merely _de minimis_ amounts to proposed projects or projects under construction will be entitled to the full amount of credit with respect to the project's cost.

Finally, INGAA believes that the proposal to accelerate estimated corporate tax payments to 90 percent should be amended. Because it will be virtually impossible for most corporations to estimate their tax liability within 90 percent of actual, over the course of its current tax year, the imposition of a penalty for the failure to properly estimate taxable income is unreasonable. For example, our industry experiences unpredictable changes in taxable income because of the weather, changing consumer demands and the cyclical nature of some of our diversified activities. Therefore, we recommend that the penalty provision for an underpayment be eliminated for corporations and that a deductible interest charge be substituted.

Mr. Chairman, INGAA stands ready to work with the Committee to help reduce the projected budget deficits and get this nation back on the road to economic prosperity. We believe we have made some positive suggestions to modify the proposals you have before you, and we urge their adoption by the Committee. I appreciate the time afforded us to present our concerns, and I would be pleased to answer any questions which you or other members may have.

* * * *

The CHAIRMAN. I think it best, rather than to try to respond, we will be working with members of your staff as we try to produce a package, hopefully, that will raise some revenue without being cumbersome or too complex

Just checking the investment tax credit itself, it will cost the loss of revenue of about $20 billion in 1982. Maybe we need to look at that rather than the complicated minimum tax, if that's along the lines you suggested, or maybe some other approach.

The leasing provision mentioned by some—I think you were here this morning—is in great difficulty. That might be an understatement.

There may be some way to establish priorities as we go through the 43 different options we have right now—and I'm certain there will be more options as we finally focus on it. Just from the standpoint of perception and knowing the number of members in the Senate who have already indicated they want to get rid of it totally or mostly, that provision will probably be modified.

We are hoping to finish our hearings next week and be in a position to start marking up certain provisions in April, and in that interim we will be working with members of your staff to see if they can't give us some help. I don't mean by "help," opposing everything that we seek to do. I notice the Coal Association is even opposed to some things we haven't suggested, covering all the bases. But that doesn't help us raise any revenue. And no one wants to pay more taxes.

I assume you are also suffering from high interest rates, aren't you? And there are high deficits. We don't know how we are going to lower the deficits unless we have a combination of more spending reduction, which we are willing to do in this committee, along with perhaps some revenue increases, which we don't particularly like. But I don't know of any other alternatives.

We are not trying to punish anyone; we are trying to do what we think is necessary to bring down interest rates.

Some don't share that view. I heard Mr. Friedman this morning on one of the networks saying don't worry about the deficits, and he might be right.

Well, thank you very much. And Mr. Bedell, thank you.

Mr. BEDELL. Thank you, Mr. Chairman.

Mr. MCGRATH. Thank you.

The CHAIRMAN. Next is Mr. Trautlein and Mr. Kelley. I think Senator Heinz wanted to be here for this panel.

While you are preparing to testify, I need to meet briefly in the back room with a group, and I will be right back.

[Whereupon, at 3:38 p.m., the hearing was recessed.]

AFTER RECESS

The CHAIRMAN. I think Senator Heinz wants to participate, so what we might do is go ahead.

We will have your statements in the record. Hopefully you can summarize your statements, and then when Senator Heinz appears he can ask questions.

Don, are you first?

STATEMENT OF DONALD H. TRAUTLEIN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BETHLEHEM STEEL, AMERICAN IRON & STEEL INSTITUTE, WASHINGTON, D.C.

Mr. TRAUTLEIN. Yes, I think so.

My name is Donald Trautlein. I am chairman and chief executive officer of the Bethlehem Steel Corp. I am appearing today on behalf of the American Iron & Steel Institute, which represents 67 companies which produced more than 90 percent of the steel made in America.

Since November 1980, individual steel companies have announced modernization programs which total more than $6.9 billion—you might say $7 billion. The expected returns on these investments is a major factor in revitalizing the steel industry.

The steel company modernization programs would not have been undertaken without the strong belief that the President's tax and economic programs would remain intact and eventually be of substantial benefit to the industry. We agree with the thrust of the President's program and believe that it must be given an opportunity to succeed.

The most distressing feature of the administration's recent tax recommendations is the extent to which they offset the benefits of the Economic Recovery Tax Act before the incentive effects can even begin to be felt. This instability in tax policy which is inherent in this decision may very well erode the confidence of the business community in the administration's overall economic policies.

We are very concerned that the administration's proposal would reverse more than one-half of the business tax reductions granted in the period 1982 to 1985. One-third of the revenue increase would come from the alternative minimum tax, which would impact especially hard on the low-profit capital-intensive companies which are in the greatest need of cash for investments in productive assets.

The net effect of this reversal in the steel industry will almost certainly be a cancellation or a deferral of a major part of the announced modernization program. The proposal for an alternative minimum tax on corporations is a classic example of taking a bad law and making it worse.

We agree with the administration that the current add-on minimum tax should be repealed. In fact, in 1978 this committee reached the conclusion that the add-on minimum tax, and I quote, "does not serve well either the goal of tax equity or the goal of encouraging capital formation and economic growth by means of tax incentives."

The proposed alternative minimum tax retains the counterproductive elements of the existing law and adds several features which make it even worse, including the fact that a substantial alternative minimum tax could be incurred even though a company had no items of tax preference. In fact, the Treasury estimates that about half of the revenues anticipated to be raised by the alternative minimum tax come through a deferral of the application of carryover investment tax credits, which are almost universally associated with low-profit capital-intensive companies. This provision is directly contrary to the clear intent of ERTA to provide investment incentives.

This impact is so severe in the steel industry that six companies, representing about two-thirds of the domestic raw steel production, have reported that the aggregate increase in tax payments for the 3 years 1983 to 1985 under the alternative minimum tax would be $634 million. This tremendous cash drain comes, as everybody knows, during, or hopefully near the end, of a period of severe economic decline.

The alternative minimum tax circumvents other existing statutes and selectively limits or repeals the incentives for which they were enacted. The concept of an alternative minimum tax is simply bad tax policy, and it should be rejected.

Now, the steel industry was an early supporter of a capital cost recovery system, even though it was recognized that the major benefits of such a provision could not be realized until the industry became more profitable. We believe that the ACRS system is a good tax policy which is beneficial for the country.

Congress realized that the ACRS provisions would provide little direct benefit to many low-profit capital-intensive industries and further understood that some mechanism had to be found in order to permit these industries to participate more fully in the intended incentives. The safe harbor leasing rules provide such a mechanism.

In 1981 the steel industry generated some $250 million of cash through safe harbor leasing, and it was expected that the provision would be an important source of cash in the future. Now the administration has not formally suggested that the safe harbor leasing rules would be repealed or amended, but we recognize that there is a growing pressure to either repeal or substantially modify them.

We urge this committee not to abandon the basic industries of this country now, when internally generated funds so essential to modernization plans are so severely curtailed.

The situation in the steel industry is critical. The industry is operating in the first quarter at about 60 percent of capability, and about 25 percent of the work force is either on layoff or working a short week.

If any changes are needed in the provisions, they should deal only with the extreme cases and not alter the basic thrust of the provisions.

In conclusion, it is worth noting that most steel companies have stated that if the safe harbor leasing rules are repealed and an alternative minimum tax is enacted, their tax burdens would be substantially higher than they would have been before passage of the Economic Recovery Tax Act.

Thank you, Senator.

The **Chairman**. Mr. Kelley.

STATEMENT OF JOHN L. KELLEY, VICE PRESIDENT, TAX, CLEVELAND-CLIFFS IRON CO., ON BEHALF OF MINIMUM TAX COALITION, WASHINGTON, D.C.

Mr. **Kelley**. Mr. Chairman, and other distinguished members of the committee, I am John L. Kelley, vice president, tax, the Cleveland-Cliffs Iron Co. I represent the Minimum Tax Coalition, a group of mining, railroad, shipping, and steel companies vitally concerned and affected by the President's minimum tax proposal.

Let me say at the outset, the companies I represent are most appreciative of the extraordinary achievements by the administration and members of this committee in the last year to lay the foundation for a major reindustrialization effort and to assist U.S. corporations in their ongoing battle with subsidized foreign competition. We are grateful for this unprecedented accomplishment which we believe will prove in the immediate years ahead to be of extraordinary benefit to workers, industry, and the economic health of the Nation.

Given our strong support for the Economic Recovery Tax Act of 1981, you may understand it is with a sense of dismay that I come before you today to strongly oppose the administration's minimum tax proposal of 1982. This proposal is a badly timed policy reversal which should not be enacted by Congress. If passed, it will cripple economic recovery for certain vital segments of American industry, reverse important tax policies established less than 1 year after they were enacted, and devastate a major effort currently underway to retool America's basic industries to allow them to compete effectively with their counterparts in other industrialized nations.

Let me explain why we oppose this tax initiative.

First, this policy reversal upsets investment incentives in the 1981 tax act. I urge you not to underestimate the importance of a consistent tax policy on long-term investment decisions. The effect of the President's minimum tax proposal will be to selectively offset tax incentives to capital-intensive industries vital to our national security and our industrial base less than 1 year after those same investment incentives were strengthened by Congress. This result will seriously erode business confidence in Government and adversely affect strategic planning decisions being made by industry.

Second, this proposal undermines established capital formation objectives. The proposed minimum tax is, more than anything else, as has been indicated here today, a tax on the investment credit. The administration's proposal blunts the benefits of this tax incentive by not allowing a company to use the investment credit to reduce its minimum tax liability. This significantly hinders the ability of many capital-intensive companies to fully utilize the credit to generate needed cash flow. Moreover, to the extent that the minimum tax does attach to items named as preferences, the selection of many of these special deductions and exclusions is unwise and counterproductive.

Third, depressed industries which can least afford it will be the hardest hit by this proposal. Corporations experiencing low profitability in capital-intensive industries use most of the funds that they generate internally to keep their existing facilities in operation. As a result of the investment incentives provided for in the 1981 act, internal funds in the mining, railroad and steel industries are now being freed up to make the necessary investments in plant and equipment to increase productivity. Because of their economic position, these industries will be forced to divert critical funds away from their capital-investment programs in order to pay this new, expanded minimum tax. In certain instances, some companies in the coalition will actually be worse off under the proposed minimum tax than they would have been had the 1981 act never passed Congress.

In addition, this minimum tax proposal comes at a time when these industries are bearing the brunt of the current recession.

Fourth, the minimum tax places domestic industry at a serious competitive disadvantage. America's basic industries are engaged in an economic war with their foreign competitors, many of which receive various types of government encouragement. If the United States is to win this battle, there needs to be a massive infusion of new funds into American industry to increase productivity, stimulate the economy and create jobs. Last year's act has, for the first time, severed certain restraints that historically have caused a serious international disadvantage to the U.S. private enterprise system, and these necessary and long-awaited changes should not be reversed.

Fifth, the minimum tax may encourage an over-centralization of industry through tax-induced mergers.

Mr. Chairman, the coalition I represent understands something of the budget pressures you and the members of the committe face this year; however, we believe the tax incentives in the 1981 act will work if they are just given time to work; the long-term benefits in jobs, economic growth and Government revenues will emerge if they are given time to emerge.

We strongly urge that the administration's minimum tax proposal be defeated and that the existing add-on minimum tax be repealed.

Thank you.

[The prepared statements of the previous panel follow:]

American Iron and Steel Institute

Written Statement Submitted by the
American Iron and Steel Institute to the
Finance Committee, U.S. Senate
March 18, 1982

This statement is submitted on behalf of the American Iron and Steel Institute and its 67 domestic member companies, which together supply approximately 92% of the iron and steel produced in the United States. The companies currently employ more than 350,000 workers in their iron and steel operations and have over 800,000 shareholders.

The American Iron and Steel Institute is in complete accord with the objectives of the Administration's overall economic program. The Institute is in favor of reduced Federal government involvement in the private sector, and particularly the Administration's efforts to get government spending under control in order to reduce the size of the Federal budget. Since November 1980 individual companies in the steel industry have announced modernization programs which in the aggregate total more than $6.9 billion of capital investments. This is greater than any amount for a comparable period since World War II. Investments for modernization in this magnitude, and the expected return in profits have been acknowledged by the President to be the key to revitalizing the steel industry.

The domestic steel industry has been weakened by many years of dumped and foreign subsidized steel imports, government price controls, enormous environmental control costs, and recently by two years of depressed steel demand. The steel company modernization programs would not have been undertaken without the strong belief that the variety of capital formation tools made available when the Congress adopted the President's tax and economic programs last year would eventually be of substantial benefit to the industry. Internally generated funds are not sufficient and external financing for steel plant purposes is not a practical alternative because of the industry's already heavy debt and uncertain future prospects.

Reversal of last year's business tax cuts is ill-conceived

The most distressing feature of the Administration's collective tax recommendations is the extent to which they offset the benefits of the Economic Recovery Tax Act before the incentive effects can even begin to be felt. The apparent instability in tax policy which is inherent in this decision may very well erode the confidence of the business community in the Administration's overall economic policies.

In relation to prior major tax bills, the Act was not overly generous to business in the first place with only about 20% of the total benefits in most years directed to business cuts. Therefore, when the Administration proposes that more than half of the reductions granted in the period FY82 to FY85 should be reversed, it is more than a cause for concern, it is alarming. This is especially true in the case of the steel industry since a major part of the revenue increase would come from the alternative minimum tax which would impact especially hard on low profit capital intensive companies, like steel.

These industries received relatively little of the immediate benefit of the Economic Recovery Tax Act and would be asked to sacrifice a disproportionate amount.

The net effect of this reversal on the steel industry will almost certainly be a cancellation or deferral of a major part of the announced modernization programs.

Alternative Minimum Tax

The proposal by the Administration to impose an alternative minimum tax on corporations is a classic example of taking a bad law and making it worse. We can agree with the Administration that the current add-on minimum tax should be repealed as it applies to corporations. This Committee, in its Report in connection with the Revenue Act of 1978, reached the conclusion that the add-on minimum tax "does not serve well either the goal of tax equity or the goal of encouraging capital formation and economic growth by means of tax incentives." Although the conclusion was reached in analyzing the individual minimum tax, it has equal applicability to corporations. It raises little revenue but takes a disproportionate share from the mining and steel industries. It selectively reduces the tax incentives intended to be provided by other carefully considered provisions of the tax code, and in some cases has rendered the intended incentives virtually worthless. Most importantly, it does not assure the extraction of a modest tax from prosperous corporations which may have some preference items as much as it does assure that selected corporations in cyclical industries are penalized in times of economic distress.

The proposed alternative minimum tax retains the counterproductive elements of the existing law and adds several features which make it even more objectionable. It has been claimed that a principal reason for this tax is to ensure that all corporations with large "economic incomes" will pay some tax. We strongly suspect that one goal of this tax is to force companies with worldwide "economic income" which have no U.S. tax liability to pay some U.S. tax. The provision will be ineffective if the company has no U.S. income or has sufficient foreign tax credits to offset the alternative minimum tax, which will generally be the case. Furthermore, in examining the provisions, it is clear that the more adverse impact will continue to be on low profit capital intensive industries such as steel which are in the greatest need of cash for investment in productive assets. In addition, since a substantial alternative minimum tax could be incurred even though a company has no items of tax preference, we are convinced that the tax is not intended to address excesses associated with tax shelter activities, which was the original intent of the minimum tax.

Rather, the primary objective seems to be to defer the application of unused investment tax credits which had been accumulated in prior years. In fact, the Treasury estimates that about half of the revenues anticipated to be raised by the alternative minimum tax come via this deferral. It is bad enough that this provision is directly contrary to the clear intent of the Economic Recovery Tax Act, even worse it impacts primarily on those companies with unused investment credits which are most universely low-profit capital intensive companies. This impact is so severe in the steel industry that six companies representing about two-thirds of the domestic raw steel production have reported that the aggregate increase in tax payments for the three years 1983-5 under the alternative minimum tax would be $634 million. This tremendous cash drain does not come at a time of great prosperity, but rather during or at the end of a period of severe economic decline. It is totally illogical to require the payment of a greater tax in times of economic recession, and then provide a credit to reduce future taxes in more prosperous times. Where the credit is deferred for a substantial period, it is effectively negated.

The Alternative Minimum Tax would circumvent other existing statutes and selectively limit the incentives for which they were enacted. The concept of an alternative minimum tax is simply bad tax policy and it should be rejected. If Congress has any concerns about the effectiveness, equity or propriety of any provisions of the tax law, it should deal with those provisions directly, and not indirectly through a minimum tax.

Safe Harbor Leasing

The steel industry had been an early and vocal supporter of the concept of a capital cost recovery system such as ACRS to replace the outdated accounting based theory of depreciation. This was true even though it was recognized that the major benefit of such a provision could not be realized until the industry became more profitable. We believed then, as now, that the ACRS system is good tax policy which is beneficial for the country, because it would stimulate investment, foster productivity, and in general improve economic conditions.

Congress realized that the ACRS provisions would provide little direct benefit to many low profit capital intensive industries, and further understood that some mechanism had to be found in order to permit these industries to participate more fully in the intended incentives. The safe harbor leasing rules which were ultimately adopted rather than investment tax credit refundability or transferability, provided such a mechanism. Not to have adopted these provisions would have meant that the incentives would have been available only to the established prosperous companies which were less in need, denying them to those companies which need the most help in restoring themselves to a profitable status.

In 1981 the steel industry generated some $250 million of cash through safe harbor leasing. It is expected that this amount would be nearly double in 1982, and that the provision would be an important source of cash in the future.

There are two important economic factors associated with safe harbor leasing that have not received a great deal of publicity. First, it is essentially a timing device which permits less profitable companies to receive an infusion of cash now rather than in the future. No additional deductions or credits are created in leases between taxable corporations. Second, it is frequently only a short-term phenomenon. Leasing is economically practical only for those companies which do not expect to use their investment tax credits fully within a two- or three-year period. As the leasing activity associated with the current year assets eliminates new investment tax credits, the backlog of unused credits may be worked down rather quickly to a point at which leasing is no longer desirable. The mechanism would have served its purpose of permitting less profitable companies to share in the incentives provided by ACRS until they return to profitability.

The Administration has not suggested that the safe harbor leasing rates be repealed or amended. We recognize that there is growing pressure; some political, some economic, to either repeal the safe harbor leasing provisions outright or to modify them so drastically, perhaps by reinstating provisions of the prior law, as to make the benefits essentially unavailable to the steel industry. We urge this Committee not to abandon the basic industries of the country in a time of recession, when internally-generated funds so essential to modernization plans will be so severely curtailed. The situation in the steel industry is critical. The industry's operating level in the first quarter is only about 60% of capability, and about 25% of the existing work force is either on layoff or working a short week.

If any changes are deemed to be necessary, they should be limited to restricting extreme applications, and should not alter the basic thrust of the provision. The law should not be amended in any way which would inhibit the ability of the steel industry to share in the incentives provided by the Economic Recovery Tax Act of 1981. It is worth noting that most steel companies have stated that if the safe harbor leasing rules are repealed and an alternative minimum tax is enacted, they would be substantially worse off than they would have been before enactment of the Economic Recovery Tax Act.

As a closing comment on this subject, we urge the Chairman to reconsider his stated intention to apply any changes in the leasing rules retroactively to February 19th. Any changes should be made prospectively, after the Committee has heard from all interested parties, and after the Treasury has had an opportunity to analyze reports submitted with respect to 1981 lease transactions.

Energy Tax Credits

The decision of the Administration to seek repeal of the existing Energy Tax Credits is also not advisable. Many companies have already made plans or commitments which would insure an orderly transition following the termination of most of the energy credits at the end of 1982. Others have begun projects which take several years to complete, based on the understanding that the credits would be available in the future. Rather than terminate the credits, we would hope that this Committee would consider extending and expanding this incentive.

Industrial Development Bond Financing

Several steel companies have made extensive use of industrial development bond financing over the past several years to fund the substantial expenditures required for air and water pollution control. The current provisions represent a reasonable method of providing financing for these non-productive assets. The Administration's proposed changes would severely restrict this type of financing, thereby limiting the industry's ability to make expenditures for modernization as well as unproductive pollution control facilities. State and local governments are now being faced with decreasing federal revenues. In our opinion it is unlikely that local governmental units would have the ability to assume a burden of contributing to pollution control projects financed with industrial development bonds.

TESTIMONY OF JOHN L. KELLEY, VICE PRESIDENT—TAX, THE CLEVELAND-CLIFFS IRON CO.

Mr. Chairman, and other distinguished members of the Committee, I am John L. Kelley, Vice President-Tax, The Cleveland-Cliffs Iron Company. I represent the Minimum Tax Coalition, a group of mining, railroad, shipping, and steel companies vitally concerned and affected by the President's minimum tax proposal.

Let me say at the outset, Mr. Chairman, the companies I represent are most appreciative of the extraordinary achievements by the Administration and Members of the Committee in the last year to lay the foundation for a major reindustrialization effort, and to assist U.S. corporations in their ongoing battle with subsidized foreign competition. We are grateful for this unprecedented legislative accomplishment, which we believe will prove in the immediate years ahead to be of extraordinary benefit to workers, industry, and the economic health of the nation.

Given our strong support for the Economic Recovery Tax Act of 1981, you may understand it is with a sense of dismay that I come before you today to strongly oppose the Administration's minimum tax proposal of 1982. This proposal is a badly-timed policy reversal which should not be enacted by Congress. If passed, it will cripple the hopes of economic recovery for certain vital segments of American industry, reverse important tax policies established less than one year after they were enacted, and devastate a major effort currently underway to retool America's basic industries to allow them to continue to compete effectively with their counterparts in other industrialized nations.

Background

The fundamental objective of the tax incentives provided to business in the Economic Recovery Tax Act of 1981 was to increase employment and economic growth through the reindustrialization of American business. The long-term goal was to ensure that U.S. industry had the incentives to continue to match and surpass its foreign competitors. The Act was aimed at infusing new capital into industries such as mining, railroads, shipping, and steel which have been staggered by heavy tax burdens, compared to that experienced by their competitors overseas.

These industries have responded to the opportunities afforded in the 1981 Act by pumping billions of dollars into new plant and equipment in the past year. The steel industry alone has announced well over $6 billion in capital spending in the last year, more than any other comparable period for this industry since World War II. The mining and railroad industries have also made major commitments to capital investment programs partially in response to the incentives provided in last year's tax bill.

Just as the reindustrialization effort has begun to gather steam, however, the President has offered a minimum tax proposal which would deal a deeply damaging blow to the move to retool American industry. The Minimum Tax Coalition is a group of companies concerned that this proposal will have a particularly serious effect on depressed, capital-intensive industries in their efforts to increase productivity and outperform business in other industrialized nations. The Coalition believes the concept of an alternative minimum tax is extremely harmful to certain segments of American industry and should not be enacted for the reasons enumerated below. The Coalition also believes that for many of the same reasons, the existing add-on minimum tax should be repealed.

This Policy Reversal Offsets Many Investment Incentives in the 1981 Tax Act

Last year's Act offered important incentives for capital spending in new plant and equipment. Capital investment, however, requires consistent government policies, and the long-term success of the reindustrialization of American industry will depend importantly on a sense of continuity and trust between government and business. The effect of the President's minimum tax proposal will be to selectively offset tax incentives to those capital-intensive industries vital to our national security and our industrial base less than one year after those same investment incentives passed Congress. This result will seriously erode business confidence in government and adversely affect strategic planning decisions being made by industry.

This Proposal Undermines Capital Formation Objectives

The proposed minimum tax is, more than anything else, a tax on the investment credit. It will also be haphazard in application as it distorts the central concept of tax credits: neutrality.

The investment tax credit was enacted to promote capital spending in plant and equipment by reducing a corporation's income tax by the amount of the credit. Like all credits, the investment tax credit is designed to provide a uniform tax result among corporate taxpayers.

The Administration's proposal blunts the benefits of this tax incentive by not allowing a company to use the investment credit to reduce its minimum tax liability. This significantly hinders the ability of many capital-intensive companies to fully utilize the credit. And this result occurs without even naming the investment credit as an item of preference. Further, corporations with no tax preferences may be subject to minimum tax liability, while others with abundant tax preferences may not.

To the extent the minimum tax does attach to items named as preferences, the selection of many of these special deductions and exclusions is unwise and counterproductive. These so-called preferences were enacted into law to stimulate capital formation and to provide for badly needed investment. The taxpayers who need these incentives most, and who have responded by making the desired investments, are the very ones who will be penalized by this proposed minimum tax.

Depressed Industries Will Be the Hardest Hit by This Proposal

The President's minimum tax proposal will have the unfortunate effect of hitting especially hard those industries which can least afford it.

Corporations experiencing low profitability in capital-intensive industries use most of the funds they generate internally to keep their existing facilities in operation. Because of the investment incentives provided for by the Economic Recovery Tax Act of 1981, internal funds in the mining, railroad, shipping, and steel industries are now being freed up to make the necessary investments in plant and equipment to increase productivity. However, as a result of the minimum tax proposal, fourteen companies in the mining industry will have to pay some $300- $400 million in additional taxes over the next three years. Six major companies in the domestic iron and steel industry, also undergoing a major reindustrialization effort, will have to pay well over half a billion dollars in additional taxes over the same period. Because of their economic position these industries will be forced to divert critical funds away from their capital investment programs in order to pay this new, expanded minimum tax.

It is important to understand that the investment tax credit, as presently structured, provides a valuable source of investment funds for these capital-intensive industries. The President's minimum tax proposal would, in most cases of capital-intensive companies, substantially defer or cancel about 25 percent of the value of the investment tax credit. In certain instances, some companies in the Coalition will actually be worse off under the proposed minimum tax than they would be had the 1981 Tax Act never passed Congress.

In addition, this minimum tax proposal comes at a time when these industries are bearing the brunt of the current recession. The capital-intensive industries represented by the Coalition are facing depressed demand, declining production, and high rates of unemployment. An increase in taxes at this time will only exacerbate an already difficult economic situation, further hindering vital reindustrialization efforts.

The Minimum Tax Places Domestic Industry at a Serious Competitive Disadvantage

Foreign government encouragement of productivity and reindustrialization in their own industry has generally placed U.S. business at a serious competitive disadvantage. It is estimated that Japan, for example, spends some 21 percent of its GNP on industrial investment while the United States spends only about 10 percent. To illustrate further, in 1968 Toyota spent some $16,600 per employee on equipment and machinery, while General Motors spent about $11,900. By 1978 Toyota was spending $40,800 per employee. General Motors' ratio remained the same at $11,900.

America's basic industries are engaged in an economic war with their foreign competitors. If the United States is to win this battle, there needs to be a massive infusion of new funds into American industry to increase productivity, stimulate the economy, and create jobs. The Economic Recovery Tax Act has for the first time severed those restraints that historically have caused a serious international disadvantage to the U.S. private enterprise system. The Administration's minimum tax proposal would again deprive many capital-intensive industries of this long awaited and crucial equalizing force in exchange for only a minor increase in Treasury revenues.

If the private enterprise system is to survive and prosper in the face of nationalized and foreign government-supported competition, this country must provide the industrial segment of its economy with the necessary tools through an economically viable income tax system. The minimum tax only places an artificial restraint on this type of industrial investment and growth.

The Minimum Tax May Cause an Overcentralization of Industry

An unintended effect of this tax proposal may be the further centralization of American industry as the minimum tax may encourage the takeover of capital-intensive industries by wealthier corporations. Such tax-induced mergers clearly are not in the national interest, having the dangerous long-term result of overcentralization of major industrial segments of the economy.

Conclusion

Mr. Chairman, the Coalition I represent understands something of the budget pressures you and Members of the Committee face this year. We face similar pressures in our businesses every day. We agree that reducing the federal deficit is vital to the long-term strength and security of the nation.

However, the Coalition would ask the Committee not to reverse much of last year's legislative accomplishments. We believe the incentives in the Economic Recovery Tax Act of 1981 will work, if they are just given a reasonable period of time to work. The long-term benefits in jobs, economic growth, and government revenues will emerge, if they are given time to emerge. Faced with immediate short-term budget pressures, we recognize we are asking much of you. But we also firmly believe we are on the threshold of a new era of economic growth and strength for American industry.

In weighing the best course of action to decrease the federal deficit, it is vital that fundamental policy goals established last year not be sacrificed for minimal benefits and short-term gains. We believe that succumbing to the temptation to expand the minimum tax will achieve only limited political and revenue benefits at a disasterous long-term cost to the nation.

The Minimum Tax Coalition believes the Administration's minimum tax proposal is a poorly-timed policy reversal which will be highly damaging to key segments of American industry hardest hit by the present recession. It cripples hope for a quick economic recovery by these industries, effectively reverses important tax policies passed less than a year ago, and may well encourage trends toward overcentralization of U.S. industry. At the same time, the proposal will unfairly burden capital-intensive corporations during their reindustrialization effort, an effort which is absolutely vital if American industry is to continue to compete with, and ultimately overtake, its foreign competition.

We strongly urge that the Administration's proposal be defeated and that the existing minimum tax be repealed.

PARTICIPATING COMPANIES - THE MINIMUM TAX COALITION

AMAX, INC.

ARMCO, INC.

BETHLEHEM STEEL CORPORATION

CANNELTON INDUSTRIES, INC.

CARBON INDUSTRIES, INC.

THE CLEVELAND-CLIFFS IRON COMPANY

CSX CORPORATION

FMC CORPORATION

THE HANNA MINING COMPANY

INLAND STEEL COMPANY

MOORE MCCORMACK RESOURCES, INC.

NATIONAL STEEL CORPORATION

PITTSTON COAL COMPANY

REPUBLIC STEEL CORPORATION

ST. JOE MINERALS CORPORATION

TEXASGULF, INC.

WHEELING-PITTSBURGH STEEL CORPORATION

The CHAIRMAN. How long do you think we have to wait for this to happen?

Mr. KELLEY. Well, I think we should be willing to wait for more than the half year.

The CHAIRMAN. We are willing, but we don't see any signs of it, and I think one reason is the unpredictability and uncertainty. I know you like a consistent tax policy; I don't quarrel with that, but there's a little thing that intervened called a recession, which would indicate to many of us that we need to go back and make some adjustment to take care of that.

The thing we are plagued with now are high deficits and high interest rates and a lot of people out of work, particularly in the poor industries. Maybe we are not approaching that in the right way, but unless we can reduce the deficits we don't see any chance of improving the general economic condition regardless of the program that may be in place.

At least you didn't come here saying we ought to take away the individual's cut and not bother business. We heard that in the morning from some of the business groups. We are not about to do that, I don't think.

We've got a problem. We appreciate your willingness to discuss it, but you don't offer any help. You are against everything we want to do to raise revenue, unless I missed something.

Mr. TRAUTLEIN. Well, if I may, Senator, the estimated impacts on the safe-harbor leasing provision, as I understand it, are about $3 billion. Now, I am not saying that that's not a large number, but when we are talking about a budget deficit that may run as high as $150 billion, it's a pretty small issue to take away the seed corn of the basic industries of this country and to mortgage what I think is the long-term future of some of these industries for that kind of a figure.

The CHAIRMAN. Well, that's not the only thing. You are also opposed to the minimum tax which, depending on which one we have, is several billion dollars. Pretty soon you are up to $10 billion, up to $20 to $30 billion. How high do we have to go to make it significant? Maybe we would just reduce the ITC's. Maybe that would be a lot easier than trying to figure out a minimum tax. That's sort of what I am getting here today.

Mr. TRAUTLEIN. Obviously, if you want to substantially close the kind of gap that we are talking about, you've got to look at both increasing revenues and reducing expenditures. We all appreciate that.

The CHAIRMAN. We are going to do that in our committee. We are not trying to run from the spending side, because we have most of the entitlement programs, and we believe that we must address entitlements.

Mr. TRAUTLEIN. Surely.

The CHAIRMAN. I think we will achieve or exceed the President's goal in that area.

We haven't done anything yet, you understand. There cannot be one vote to do anything in this committee, except for safe-harbor leasing. I would guess there are adequate votes to do most anything with that.

Mr. **Trautlein**. That would be very unadvisable, I have to say, from the standpoint of the seven or eight basic industries in this country, unless something is substituted for it.

The **Chairman**. Right. Well, we are looking at 43 options on the leasing provision now.

Mr. **Trautlein**. I think, if I may, so much perception has been placed on the fact that companies have reduced their tax liabilities, without looking at the fact that so many companies have been able to take advantage of the tax incentives now rather than in the future and put their money into capital programs.

Now, I think the gentleman sitting at my right, here, is right. I mean we've got to give this thing more than 6 or 9 months to work. But the steel industry itself has announced modernization programs to $7 billion. It's the highest ever in history, and we are engineering for that now. And now we are faced with whether we cancel or defer, or what? I can't overemphasize—it's a critical decision for us.

I think there are ways to raise tax revenues from the business sector other than through taking away the ability for the basic industries to use the incentives as they were intended.

The **Chairman**. It would be very helpful if you would give us a list of those. Hopefully, everybody gets to contribute. That's the point.

Mr. **Trautlein**. I agree with you on that.

The **Chairman**. Having said that, I am going to turn it over to Senator Heinz, who is probably the strongest defender you have on this committee on any matter that would deal with the steel companies. He has agreed to conclude the hearing. I think maybe he wanted to ask ome questions.

I appreciate very much your appearing.

Mr. **Trautlein**. Thank you, Senator.

Mr. **Kelley**. Thank you, sir.

Senator **Heinz**. Mr. Trautlein, you started to say something about the effect on the steel industry's modernization plans, 7 billion dollars worth of investments. If I heard you right, those are all commitments made only subsequent to the passage of last year's Tax Act?

Mr. **Trautlein**. That's right, at least since November 1980. But I think most of them were either done after the passage of the act or at least in anticipation of the passage. So I think you could say they were done in association with it.

Senator **Heinz**. Is it possible to figure out which of those—I don't imagine you would cancel all of them—might be jeopardized by either the minimum tax or by the total repeal of safe harbor leasing with nothing to replace it?

Mr. **Trautlein**. In my statement I referred to the fact that the alternative minimum tax, alone, in the next 3 years, that is, 1983, 1984, 1985, it is estimated that it would cost $634 million.

Senator **Heinz**. Just on the steel industry?

Mr. **Trautlein**. On the steel industry. And I did indicate that we sold safe-harbor leases last year of $250 million, and we would have expected to sell about $500 million this year. So if you can project the 500 for 3 years and add 600 to it, it would get up to about $2 billion there, and if that isn't going to be available——

Plus, what does that do for you to make other funds available in the credit markets, if they improve? So I feel quite sure that you are looking at a significant, as I said, deferral or cancellation of these programs.

Senator **Heinz**. Well, one member of the AISI, who shall be nameless, but we all know who it is, just spent $3 or $4 billion acquiring some oil company in Ohio. And you are telling us that $634 billion will cause a real problem in the steel industry, when just one company went out and paid $3 or $4 billion for Marathon.

Now, how do you reconcile those two facts?

Mr. **Trautlein**. Well, I don't really want to comment on that.

Senator **Heinz**. Well, you don't want to; I understand. But this is the question that is going to be asked. I just happen to be sitting here, all by myself, and I'm the one who has to ask it; because if it doesn't get asked, the record will be blank, and people will use it rhetorically. So it is important there is an answer to it

Mr. **Trautlein**. Well, it should be answered, and I think that company has answered it. And I know they would be pleased to furnish an answer to this committee.

Senator **Heinz**. But, you see, it's not a question of what company has an answer; it's a question of when you sit here and say, "Gee, if you tax us to the tune of $634 million more, that's going to mess up not just one company, but the industry," at the same time that a member of the industry paid cash for a company in another line of work.

Mr. **Trautlein**. Yes.

Senator **Heinz**. So, the question is, If one company can pay cash that is four, five, six, seven times over what you are saying is unaffordable, why, if they can do it, can't the rest of the industry do it to some kind of an extent?

Mr. **Kelley**. Senator.

Senator **Heinz**. Yes.

Mr. **Kelley**. I don't want to answer for the other company, but they also sold a substantial amount of coal reserves this same prior year.

Senator **Heinz**. They didn't sell 3 or 4 million dollars, worth of coal reserves.

Mr. **Trautlein**. Well, it was about $1 billion, and there was also the sale of some cement companies and other—but, again, I am trying to talk about an industry position.

Senator **Heinz**. So am I.

Mr. **Trautlein**. But what one company was able to do——

Senator **Heinz**. Look, Don, you understand my position. I am the chairman of the Senate Steel Caucus and the Coal Caucus both with 58 Senators. Now, if you are going to make a case and we are going to be convincing about what it takes to save the steel industry, we've got to be convincing. And mumbling by me or anybody else isn't very convincing.

Mr. **Trautlein**. Well, every company develops their own strategy, but I think there should be a great concern in this country that a number of major steel companies are turning away from the steel industry. If we really want a steel industry in this country, we've got to not only provide the incentives but see that they are used.

Senator HEINZ. That's true. But the decision that we've just referred to came before anybody proposed a minimum tax, came before anybody started jumping up and down about safe-harbor leasing, came after we enacted ACRS, came after safe-harbor leasing was available. Now you have got to explain that context, because at that point in time what the Congress had done was to make capital-intensive industries more attractive than at any time in the history of this country.

Mr. TRAUTLEIN. Certainly in the last 20 years. I agree with you there.

Senator HEINZ. I would say in 40 years.

Mr. TRAUTLEIN. Yes; I agree with you. And that, of course, is what is so concerning; because, within 6 or 8 months, here we start the reversal trend.

But I really can't talk about another company's strategy.

Senator HEINZ. Apparently. [Laughter.]

Is there any way you can translate the $634 million into job losses or jobs that won't be created?

Mr. TRAUTLEIN. I am sure it could be. We could give you some estimates. What you are doing is, you are going to be less competitive. I think it would hasten the closedown of some facilities. You would have to really look at that company-by-company and what they are likely to do. I don't have a rule of thumb, but I can say without any question that there would be jobs lost. I don't think it would be a lack of jobs being created, because we are talking about retaining jobs here and not creating jobs.

Senator HEINZ. Now, nobody worked harder to get accelerated depreciation that I am aware of, at least on this side of the Capitol, than I did.

Mr. TRAUTLEIN. Yes, sir.

Senator HEINZ. I was a staunch believer, and I still am. I had an alternative to safe-harbor leasing. I wanted to make the tax credits collectible and claimable on income taxes paid all the way back to the beginning of that program in 1962 and 1963.

We now have a situation before us with the safe-harbor leasing, which AISI was for and three or four other industries are for, where it is possible—not for those particular industries, because they are not making any money; that's why they want some way of translating their tax losses into cash, because they don't have so much money and they don't have much cash, and they need it to modernize, as you have indicated.

But we have come up to a situation where other nameless companies, and we know who they are, who are the recipients or the purchasers through leases of those losses, are profitable companies and can virtually eliminate, even though they are profitable companies, their tax liability.

Now, both of you say, if I understand you, "Gee, don't touch that. And don't do anything about the minimum tax, either."

I would suggest that what drove Don Regan to propose the minimum tax is that maybe the Treasury Department really does recognize that they created a problem. And they created a monster. But you seem to want to say "No" to their solution and "No" to improving it and getting the monster under control.

Mr. TRAUTLEIN. Well, the thing is, of course, we have disagreed with the minimum tax right along, because what it does is, it takes the incentives and then it says, "Well, we give it to you on the one hand, but we take 15 percent away on the other hand."

Senator HEINZ. I can understand why you are against the minimum tax item but at the same time you have reservations about giving ACRS because, on the one hand, we want to encourage capital formation, and then we say, sorry, if you use it very much, we really didn't mean it last year when we said that.

I can understand why you don't like the minimum tax, but what I am saying is, given the fact that the minimum tax appears to be a solution to a problem that safe-harbor leasing created, while I can understand that you don't like the minimum tax, what are you prepared to do about the problem? The solution you don't like really was generated down at the Treasury. What do you want to do about the original problem?

Mr. TRAUTLEIN. I think the problem, quite frankly, is that it worked just the way it was intended to. It provided much-needed funds for the basic industries. And, by the way, as you know, there are seven or eight of them. It is not only steel and automotive, but it is paper and aircraft—you know, you go through basic industries, all of whom are capital-intensive industries.

I think it is a political problem. I understand why both the administration and the Congress are concerned about it.

Senator HEINZ. When you say-safe harbor leasing worked the way it was intended to work, to the best of my recollection safe-harbor leasing never even touched the Senate. It was inserted in the House tax bill. [Pause.]

I stand corrected.

Mr. TRAUTLEIN. I think the problem is one of perception. It would be very easy to take the profitable companies and say, "All right, you can only reduce your tax by 25 percent," or use some special number. What they have done, though, they have provided funds through this mechanism to the basic industries. The basic industries have used those funds as they were intended to be, for modernization.

So, I think we are in danger here, to use a cliché, of throwing the baby away with the bath water.

Senator HEINZ. That's probably right. What do we want to do about it?

What you are saying is, "Let's keep the baby; let's keep the bath water."

Mr. TRAUTLEIN. No, I am saying, "If the water is too hot, let's cool it off a little bit."

Senator HEINZ. Well, how?

Mr. TRAUTLEIN. Just say that no company can reduce its tax liability by more than 25 percent. If a company were supposed to pay 300, the most they could reduce their tax liability is by 75. I am just using a rule of thumb.

There are plenty of purchasers out there. You know, this is no big economic bonanza for the buyers; 85 to 90 percent of this is going to the sellers. It's going where it belongs, as you well know. And it's just too bad that there is a political perception that there's a great bonanza for the buyers of these benefits. They are paying cash.

What is happening is that people who are not now able to take advantage of these incentives are getting them moved along. It is a timing difference in terms of the Government, and the funds, in effect, are being supplied by the Government sooner than they would have been otherwise.

Senator HEINZ. Mr. Kelley, do you have any suggestions about what we do about the problem?

Mr. KELLEY. Well, for the record, I want to say that the minimum tax coalition that I represent has only one issue, and that is with the alternative minimum tax. I probably can speak to the leasing problem somewhat, but I wanted to say also that one of the crucial parts of my testimony today——

Senator HEINZ. Do you think that Mr. Regan and Mr. Reagan would have proposed a minimum tax if safe harbor leasing had not been enacted?

Mr. KELLEY. Probably not.

Senator HEINZ. OK. Then I consider you fair game.

Mr. KELLEY. But I don't mind sharing the dais with Mr. Trautlein.

First, I wanted to say that we have members in our coalition that are suffering net operating losses and investment credit carryforwards, unused, and they would become taxpayers under the administration's alternative minimum tax. And focusing on minimum tax, per se, is more of a broad consideration. I suppose there are various persons even within our organization who would favor a minimum tax that was not structured as is the administration's minimum tax.

Senator HEINZ. Senator Dole, of course, put his finger on the big problem. The problem is, we have a huge budget deficit. Huge. You know, the President thought it was $91 billion, and now he thinks it's $97 billion. The Congressional Budget Office and the budget committees of the Congress know it is a good deal higher than $97 billion. And, instead of it getting less, it's going to get higher, even if we do everything the President has asked us to do.

Now, the President, among other things, has asked us to cut spending, a lot of it in human needs areas, to the tune of $40 billion. The President is asking us to, among other things, offset as income low-income energy assistance or offset, in determining AFDC benefits, food stamps, which has the result—a little interesting result there—that people with the lowest incomes will get the least benefit from food stamps because their income will be offset by a larger amount of food stamps.

So the administration is asking us to ask people, who don't have a lot, to do without. Right?

Mr. KELLEY. Right.

Senator HEINZ. Now, here you are, here, and you are asking us, "Gee, let us off the hook. We don't want to be a part. We are not proposing any solution to help you solve the budget problem. You just go ahead and reduce benefits to poor people. Great. We'll applaud. We don't have any suggestions for you."

Now, that may be. But it makes it extremely difficult for us to put together something that will be reasonable and fair.

Mr. **Kelley**. We certainly are not insensitive to the problems that you are talking about. When I came in today, Congressman Bailey was the first witness. He strongly appealed to the Senate and the Senate Finance Committee to address specific problems, if there are any, in leasing or elsewhere. If we have a section of the tax law that is too rich, it can be fine tuned—that was his recommendation—we wholeheartedly support that.

The major economic problem with the alternative minimum tax that the administration proposes is that it, in essence, for all intents and purposes in cashflow terms, repeals investment tax credits from investments that were carried over from past years.

Senator **Heinz**. Mr. Kelley, I understand that.

What I am suggesting, though, if you want to help your own cause, maybe you, as I think Don Trautlein committed to doing to Senator Dole—he may rue the day, but I think the record will show, Don, that you told Senator Dole you would come up with a list of alternatives.

Mr. **Trautlein**. Yes, sir.

Senator **Heinz**. You could help your own cause by doing the same thing, even though I understand that you are a single-issue interest group; but, nonetheless, in this case the issues are relatively inseparable.

I can't resist this: Do you believe in single-issue politics?

Mr. **Kelley**. No; but I didn't come to testify on politics. [Laughter.]

Senator **Heinz**. That was a dirty question to ask. And, as they say, "somebody had to ask it."

Mr. Kelley and Mr. Trautlein, thank you very much.

Mr. **Trautlein**. Thank you, Senator.

Mr. **Kelley**. Thank you.

[Whereupon, at 4:20 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

HEARINGS

Before The

SENATE COMMITTEE ON FINANCE

March 10-12, 16-19, 1982

On The

ADMINISTRATION'S BUDGET AND TAX PROPOSALS

STATEMENT

On Behalf Of

PETERSEN, HOWELL & HEATHER, INC.

And Its Parent

PHH GROUP, INC.

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Counsel

INTRODUCTION

This statement is submitted on behalf of Petersen, Howell & Heather, Inc., a company headquartered in Hunt Valley, Maryland, which has been engaged in the management and leasing of fleets of automobiles and trucks on a nationwide basis for over 30 years.

The purpose of the statement is to urge the Committee to address, by way of legislation, a critical problem now confronting the motor vehicle fleet leasing industry. The legislation in question, a draft of which is appended to this statement, would prevent retroactive recharacterization for tax purposes of certain binding lease contracts that include a terminal rental adjustment clause. It would also require that any prospective changes in the tax treatment of such leases be effected either by Congressional legislation or by formal Treasury Department regulations promulgated only after a policy-level study, prior notice, and an opportunity for full public hearing.

SUMMARY

Under present law, an automobile or truck used in a trade or business or for the production of income is depreciable property and is eligible for the investment tax credit. Generally, any depreciation deduction or investment credit allowable in a taxable year for a leased auto or truck is claimed by the lessor. In a National Office Technical Advice Memorandum (LTR 8019120), first published in May 1980, the Internal Revenue Service adopted a new position that the risk of ownership shifts to the user when a lease agreement contains a terminal rental adjustment clause. Under those circumstances, the transaction will be treated by the IRS as a conditional sale rather than as a true lease. Under the Service's position, the taxpayer contractually designated as the "lessor" is not allowed to claim any depreciation deduction or investment credit for the "leased" property. Moreover, the Service also stated in the Technical Advice Memorandum that it would not exercise its discretionary power under Code Section 7805(b) to apply its new position on a prospective basis only.

Terminal rental adjustment clauses have been used by the motor vehicle fleet leasing industry for more than 30 years to insure that rental payments reflect the true cost of using the vehicle during the lease term. These clauses provide a means of adjusting the total rental price of a leased vehicle, either upward or downward or both, at the end of the lease or actual use by the lessee to reflect the amount realizable by the lessor upon sale or other disposition of the vehicle.

The presence of such clauses in the standard industry lease has for three decades protected the lessor's interest in the salvage value of his fleet against neglect or abuse by lessees. Similarly, when applicable to both the lessor and lessee, a rental adjustment clause enables a lessee to reap the rewards of turning in a vehicle in such good condition that its resale value exceeds the parties' original salvage value estimate.

Notwithstanding the important business purposes served by rental adjustment clauses and its own long-standing audit position that recognized contracts with such clauses as true leases, the Service adopted its new position without benefit of any prior notice to Congress or to the public and without any public hearings allowing interested parties to express their views. Moreover, despite a subsequent ruling by the United States Tax Court in the April 1981 Swift Dodge case[1/] that the new Service position is wrong, the IRS continues to apply the new position retroactively in auditing selected motor vehicle fleet lessors.

As will be discussed more fully below, this is a clear case where retroactive application of a change of position concerning the tax effects of a contract binding on the parties ought not be permitted. Prompt legislative action is therefore necessary to insure that no changes in the tax treatment of motor vehicle leases with terminal rental adjustment clauses occur absent a change in the law or a prospective change in Treasury Department regulations after adequate notice and hearings.

THE NEED FOR LEGISLATIVE ACTION

The Internal Revenue Service's new position concerning the effect of terminal rental adjustment clauses in motor vehicle

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[1/] Swift Dodge v. Commissioner, 76 T.C. 47 (1981), appeal docketed, No. 81-7440 (9th Cir., May 15, 1981).

fleet leases is, we believe, incorrect as a matter of law. The Supreme Court in 1978 defined the proper legal standard for determining whether a transaction is to be treated as a lease or as a sale for federal income tax purposes as follows:

> "...[W]here...there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes."[2]

The legislation we are proposing, however, is not addressed to the substantive merits of this question. Instead, we are seeking to avoid the almost inestimable harm and unfairness which would result from the retroactive application of the Service's new position, whether or not that position is ultimately rejected by the courts.[3] In addition, we are also seeking to insure that future changes in the tax treatment of motor vehicle leases with terminal rental adjustment clauses will be effected only by express Congressional authority or by prospective Treasury Department regulations.

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[2] Frank Lyon & Co. v. United States, 435 U.S. 561, 583-84 (1978).

[3] We believe, however, that judicial rejection of the IRS position is inevitable. The Service's test for determining whether a transaction involving a terminal rental adjustment clause is a true lease or a conditional sale has not only been rejected by the Supreme Court in the Lyon case, supra, note 2, and by the Tax Court in the Swift Dodge case, supra, note 1, but is also at odds with several other recent cases. In Northwest

(footnote continued on next page)

The Importance Of The Vehicle Leasing Industry In The U.S. Economy

The U.S. vehicle leasing industry meets the needs of a number of U.S. industries for large quantities of motor vehicles. Firms in the vehicle leasing industry purchase large fleets of vehicles from U.S. motor vehicle manufacturers or dealers and lease such fleets to other commercial or industrial firms. The economies introduced by the vehicle leasing industry result in a highly efficient mechanism for distributing several hundred thousand cars and trucks produced in the United States each year.

The vehicle leasing industry plays an extremely significant role in the United States economy. It has been estimated that there were over 4.5 million vehicles under lease in the United States during 1980. In 1979 and 1980, vehicles purchased for lease constituted 15.5% and 16.0% respectively, of the total output of the domestic automobile manufacturing industry.

(footnote 3/ continued from previous page)

Acceptance Corp. v. Commissioner, 58 T.C. 836 (1972), aff'd 500 F.2d 1222 (9th Cir. 1974), and Lockhart Leasing Co. v. Commissioner, 54 T.C. 30 (1970), aff'd 446 F.2d 269 (10th Cir. 1971), certain of the leasing transactions at issue were structured so as to have the same economic effect as a rental adjustment clause. In both cases, the courts found that the transactions constituted true leases for federal income tax purposes.

Substantially all vehicles purchased for lease by the vehicle leasing industry are domestically manufactured.

Moreover, in times of economic recession, purchases of domestically produced vehicles by the vehicle leasing industry do not decline as fast as purchases of vehicles generally decline under those conditions. For example, the domestic car purchases by major industry members actually rose sharply during the period of precipitous decline in auto sales beginning in 1979.

The Importance Of The Terminal Rental Adjustment Clause In The Standard Industry Lease

The terminal rental adjustment clause is a mechanism designed to meet important business requirements of the fleet vehicle leasing industry. As of 1980, over 60 percent of the automobiles and trucks held under fleet leasing arrangements were subject to a standard industry lease agreement which contained such a clause.

A traditional expectation of the lessor of property is that, at the expiration of the lease, the property will be returned to him in a condition such that its residual value roughly approximates the residual value that was anticipated at the inception of the lease. The residual value of a leased vehicle is greatly influenced by the amount of use and the quality of care that it receives while under lease.

It is not administratively or competitively feasible, however, for lessor firms to police the use and maintenance of their vehicles while under lease or to determine in advance those lessee firms likely to operate the vehicles in a manner inconsistent with an acceptable residual value. Thus, fleet lessors have come to rely on the terminal rental adjustment clause as a means of reflecting the actual residual value of a leased vehicle when it is surrendered by the lessee at the end of actual use or the end of the lease term as the case may be.

When a lessee turns in a neglected, poorly maintained, vehicle which brings in less than its projected residual value, a terminal rental adjustment clause enables the lessor to recoup the deficiency from the lessee who is appropriately penalized by a rental adjustment in favor of the lessor firm. Correspondingly, the lessee who turns in a well-maintained vehicle which is worth more than the projected residual is rewarded under the terms of a terminal rental adjustment clause by a refund of a portion of the rent paid. The terminal rental adjustment thus insures that the rent charged the lessee firm reflects the actual cost of using the vehicle during the term of the lease.

Clearly the use of terminal rental adjustment clauses is based on sound economic principles which are entirely independent of tax avoidance considerations. The effect of using such a rental adjustment clause is to lower the overall cost of the leasing transaction. This is because (i) the total rent paid is based on a known--rather than an estimated--cost, and (ii) costs are borne by the party best able to control them--the lessee. It is not surprising, therefore, that the efficiencies and cost-savings associated with these clauses have led to their widespread use as indicated above.

The Harmful Economic Effects Of The New IRS Position

The new IRS position that leases containing terminal rental adjustment clauses are to be treated as conditional sales for federal tax purposes threatens to disrupt the smooth functioning of the motor vehicle industry at a time when our nation's entire economy, and particularly the automobile industry, is already on shaky ground.

First, the cost of delivering transportation capacity to U.S. industry would be increased. Allocation of the federal income tax incidents of the standard lease transaction is a crucial factor in determining the amount of rental charge. Under the traditional industry practice, the lessor firm is entitled to depreciation deductions and investment credits with respect to leased vehicles. The tax deferral inherent in the availability to the lessor of depreciation deductions and investment credits at the beginning of a lease period permits the lessor to earn a satisfactory real cash return on its investment at a lower rental charge than would have been required had the depreciation deduction and investment credits belonged to the lessee. The rent charged by a lessor firm would have to increase in order to replace the cash flow lost as a result of the Service's allocation of depreciation deductions and investment credits from the lessor to the lessee firm.

Second, application of the new IRS position to completed transactions could result in the economic destruction of some firms in the vehicle leasing industry, the overwhelming majority of which are affiliated with car dealerships already in serious economic distress. The industry is highly competitive. Profits are earned by applying relatively low profit margins to relatively high volumes of business. The typical firm has a high debt to equity ratio. Accordingly, past standard industry leases were negotiated with the expectation that depreciation deductions and investment credits would be available to the lessor firm. The enforcement of deficiencies based upon the theory that such deductions and credits do not belong to the lessor could well bankrupt some firms in the industry.

Third, general application of the new IRS position would disrupt an established system of distributing automobiles and trucks and would adversely affect the U.S. automobile manufacturing industry and the vast majority of U.S. automobile dealerships. This is a particularly shocking IRS policy decision at this time in the life of the Nation. In late 1980, new car deliveries had reached a 22-year low, car production was down to the 1955 level and manufacturers and dealers were in financial distress. Those conditions persist. Manufacturers have reported that the only consistent element in the automobile marketplace is vehicle leasing, where sales are continuing at a normal level while all other sales are sharply down. The serious national economic problem affecting automobile manufacturers, dealers and leasing companies would be made worse at this time by disrupting the customary leasing mechanism and inevitably slowing down sales for leasing purposes.

The incentive effect of the investment tax credit and the accelerated cost recovery system (ACRS) recently enacted by Congress will be diluted or defeated. The major purpose of the new system is to provide incentives to taxpayers engaged in trade or business to purchase certain kinds of income-producing property, including automobiles and trucks. The IRS position undermines the incentive effect of these provisions for motor vehicle fleet lessors and lessees by interposing a cloud of uncertainty with respect to the income tax treatment of transactions commonly engaged in for more than 30 years.

Unfairness Of Applying The New IRS Position Retroactively

The undesirable consequences of the Service's new position are compounded by the inherent unfairness of its application. The Service has made clear its intent to apply its new position retroactively. This retroactive application is occurring notwithstanding the fact that standard industry practices and contracts have evolved over a number of years based in large part on IRS audit actions and IRS decisions not to act during that time. In light of this administrative history, the Service should not now be permitted to reverse itself and apply that new position retroactively.

The question whether the lessee or the lessor should be treated as the owner of the property subject to the lease has been an issue in federal tax law at least since the 1930's.[4/] Yet despite the fact that it has known for many years that leases with terminal rental adjustment clauses were developing as standard practice in the vehicle leasing industry, the Service has never--to this date--published an official, generally applicable, statement of its position with respect to the federal income tax treatment of such leases. While it is generally assumed that Technical Advice Memorandum LTR 8019120 represents the current views of the IRS National Office, this document is officially treated as a private ruling, directed to the facts of a particular case, and as such, does not represent an authoritative announcement of the Service's position such as a revenue ruling or revenue procedure would.[5/]

We do not mean to suggest that the IRS may never take a position in litigation that is not based on previously published official statements of its views. In this particular case, however, the absence of any such published statements combined with the three specific factors discussed below reveal such a clear failure to provide proper administrative guidance to an

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[4/] See Helvering v. Lazarus, 308 U.S. 252 (1939).

[5/] It should be noted that the Technical Advice Memorandum was made public pursuant to Internal Revenue Code Section 6110, which provides specifically, that such documents "may not be used or cited as precedent," and this warning is physically stamped by the IRS on the face of the document itself.

entire industry that retroactive application of the new administrative position is clearly unreasonable and inequitable.

In the first place, on at least two occasions since the mid-1960's, the Service has specifically declined to respond publicly to submissions by certain industry representatives seeking an authoritative resolution of this question. Regardless of what the private reaction to these submissions may have been, the fact is that no public statement was made to warn lessors that the Service might take a position contrary to that urged by the industry. This failure of the IRS to act obviously contributed to the assumption that no challenge to the prevailing treatment of leases with rental adjustment clauses was likely to be forthcoming.

Secondly, prior to 1975 when Rev. Proc. 75-21 was published,[6/] lessors could not, in general, obtain private letter advance rulings from the IRS on the question whether a lease would be viewed as bona fide for federal tax purposes. Moreover, the conditions set forth in Rev. Proc. 75-21 are so specific and highly restrictive that most companies whose normal business activity is leasing motor vehicles and other types of equipment cannot avail themselves of the Service's advance ruling procedures. Yet there is no question but that many transactions which do not satisfy the conditions for obtaining an advance ruling are in

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[6/] 1975-1 C.B. 715.

every legal and economic sense true leases. Indeed, Rev. Proc. 75-21 itself states specifically: "...These guidelines do not define, as a matter of law, whether a transaction is or is not a lease for Federal income tax purposes and are not intended to be used for audit purposes...."[7/]

Perhaps most compelling, during the many years of silence from the National Office, vehicle lessors relied on the one affirmative indication of the Service's position which they did receive. The validity of leases containing terminal rental adjustment clauses was simply never challenged on audit. The major leasing companies were audited every year during this period, while others were reviewed on a more or less regular schedule. And even though in many instances revenue agents proposed adjustments which related to the method of computing depreciation on leased vehicles--which adjustments were therefore necessarily premised on the assumption that the lessor was the owner of the vehicles--the question whether a lease with such a clause resulted in a conditional sale of the vehicle to the lessee was never raised.

Finally, it is important to note that retroactive application of the Service's position will necessarily divide the auto leasing industry into two classes: those members of the industry against whom the IRS' position is enforced and those

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[7/] Id.

against whom it is not enforced whether by reason of inadequate audit coverage, running of the statute of limitations, or differing views of examining agents as to the proper application of the law. Such a result would not only be unfair, in that it applies different treatment to similarly situated taxpayers, but it also would introduce distortions in the structure of the industry's market by conferring an unfair competitive advantage on those firms against whom the policy is not or cannot be enforced.

DESCRIPTION OF THE LEGISLATION PROPOSED

The legislation which we are proposing concerning the tax treatment of terminal rental adjustment clauses in motor vehicle fleet leases is not the first legislative response to the new IRS position. Following publication of the IRS Technical Advice Memorandum (LTR 8019120), the then Chairman of the Committee on Ways and Means, Mr. Ullman, introduced H.R. 8073[8] and held hearings on it and other legislation in September 1980.[9] H.R. 8073 would have required the IRS to determine the tax treatment of automobiles and truck leases executed prior to January 1, 1981 without regard to the presence of rental adjustment clauses. This proposal was reintroduced in March 1981 as H.R. 2837[10] and, in May 1981, identical legislation was introduced in the Senate by Mr. Armstrong, of Colorado as S. 1111.[11]

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[8] H.R. 8073, 96th Cong., 2d Sess. (1980).

[9] *See* FOREIGN CONVENTION TAX RULES AND MINOR TAX BILLS: *HEARINGS* BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE HOUSE COMMITTEE ON WAYS AND MEANS, 96th Cong., 2d Sess. (September 18, 1980).

Shortly thereafter in June 1981, Congressman Gibbons introduced legislation in the House which took a somewhat different, and in our view improved, approach from that taken in the earlier bills. Under Mr. Gibbons' bill, H.R. 3857,[12] legislative action by Congress would be required before the IRS could reclassify an automobile or truck lease either prospectively or retroactively because of the presence of a terminal rental adjustment clause.

Inasmuch as it is intended to achieve the same basic purposes as H.R. 3857, our legislation differs from the Gibbons bill in only two respects. First, it covers leases of all types of motor vehicles (including trailers). Second, it would allow prospective changes in the tax treatment of motor vehicle leases with terminal rental adjustment clauses to be effected not only by Congressional legislative action but also by formal Treasury Department regulations.

Need For Procedural Safeguards As Well As Policy Level Study And Discussion Prior To Any Prospective Changes

In proposing this response to the new IRS position, we do not mean to suggest that we believe a change in the historic

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10/ H.R. 2837, 97th Cong., 1st Sess. (1981).

11/ S. 1111, 97th Cong., 1st Sess. (1981).

12/ H.R. 3857, 97th Cong., 1st Sess. (1981).

tax treatment of motor vehicle fleet lessors is warranted, even on a prospective basis. To the contrary, we view our proposal, in accordance with the theory and result of the Tax Court decision in Swift Dodge and the other leasing cases discussed above, as declaratory of existing law. Therefore, our legislation is based on the premise that neither Congress nor the Treasury Department would consider any changes in the present law unless the Department has conducted a major policy level study of the economic and tax issues bearing on the question whether there is a sufficient reason to deny fleet lessors the depreciation deductions and investment tax credits otherwise allowed owner-lessors of depreciable business property. Our draft legislation would not require such a study. However, it would certainly contemplate that no change could be made without a thorough analysis of these issues.

Moreover, if such a study indicated a need for change, our legislation anticipates that any proposals for change to be effected at the administrative level would be in the form of a major legislative regulation which would be developed by all interested policymakers within the Service, the Treasury Department and the Administration. Finally, our legislation would expressly provide that no such legislative regulation could be finally adopted until it had been considered in open, public proceedings in which, after due notice, opportunity was provided for comment and participation not only by affected business taxpayers but also by interested members and representatives of the public.

No Significant Revenue Impact Associated With Proposed Legislation

In urging the Committee to give favorable consideration to our legislative proposal, we want to emphasize that the bill should be viewed as revenue neutral. It seeks to preserve the historic tax treatment of leases with terminal rental adjustment clauses until changed either by Congressional legislation or by prospective Treasury Department regulations.

Were the IRS permitted to retroactively characterize vehicle leases with terminal rental adjustment clauses as conditional sales as it is now threatening to do, then the tax benefits of vehicle ownership would for the most part be simply transferred (where the statute of limitations is not a bar) from the lessor to the business lessee. Treasury revenues would not be significantly affected by retroactive or prospective application of the Service's new position.

At the same time, our proposed legislation would eliminate very significant and costly administrative burdens for both the IRS and the vehicle leasing industry. A retroactive IRS reclassification of these leases as conditional sales would require adjustment of virtually every vehicle lessor's tax returns. The tax returns of business lessees (who presumably took tax deductions for rental payments) would also have to be adjusted retroactively, to eliminate rental deductions, and to include instead lessee claims for investment tax credit and depreciation allowance. Tremendous confusion in audit and compliance, and uneven application of IRS' position, would result from reclassification of these leases--not to mention the substantial costs to the Government which are connected with unproductive tax controversies and litigation on an industry-wide basis.

CONCLUSION

This legislative proposal relates to the "terminal rental adjustment clause" issue. It would prevent the Service from retroactively recharacterizing a transaction negotiated by the parties as a lease as a transaction other than a lease merely because the parties have included a terminal rental adjustment clause.

The terminal rental adjustment clause has existed for more than 30 years. It was developed and has actually served important business needs of the motor vehicle leasing industry. If the IRS desires to establish a rule that an agreement containing such a clause is not a true lease, it should ask Congress for appropriate legislation. Alternatively, it should ask the Treasury Department for legislative regulations which should not be promulgated until after a policy-level study is conducted and interested parties are afforded an opportunity to be heard. Any regulation resulting from such a process would be applied on a prospective basis only.

For the IRS to proceed in individual cases on a retroactive basis is disruptive of the market place. Individual taxpayers ought not be subjected to uneven application of the tax law for any period, much less retroactively. Retroactive application in individual cases under the circumstances involved in the terminal rental adjustment clause issue is unwarranted. It exemplifies unsound, unwarranted, and discriminatory action and it violates sound tax policy.

We urge that the Committee include the attached legislative proposal in the next piece of tax legislation reported out this session.

Respectfully submitted,

Dale W. Wickham
Edward O. Craft
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Counsel to
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and its parent, PHH Group, Inc.

Attachment

ATTACHMENT

LEGISLATION TO PREVENT RETROACTIVE TAX RECLASSIFICATION OF A BINDING CONTRACT FOR LEASE OF A MOTOR VEHICLE

Insert at the appropriate place in the bill the following:

Unless otherwise hereafter provided by statute or by prospective regulations (which may not be effective in respect of any contract entered into in any taxable year beginning on or before the date such regulations are published in the Federal Register) prescribed by the Secretary of the Treasury after notice and opportunity for public hearing, the treatment by any lessor of any motor vehicle (including a trailer) subject to a lease as property of a character subject to the allowance for depreciation shall not be disturbed for any taxable year (whether ending before or after the enactment of this Act) by reason of the presence in such lease of a terminal rental adjustment clause which permits or requires rental price to be adjusted upward or downward by reference to an amount realized by the lessor upon sale or other disposition of such property.

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March 19, 1982

BY HAND

Robert Lighthizer, Esq.
Chief Counsel
Senate Finance Committee
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Lighthizer:

We represent the Council of State Hospital Finance Authorities, which, through its Acting Chairman, George C. Phillips, Jr., appeared at the Committee hearings on revenue proposals on Wednesday.

We would like to submit for the record a copy of a forthcoming article by Mr. Phillips entitled "Tax-Exempt Hospital Bonds: Key Questions and Answers," which will appear in the April 1982 issue of Hospital Financial Management Journal, Vol. 36, No. 4.

Thank you for your attention to this matter.

Yours truly,

Stanley I. Langbein

cc: Walter Unger ✓

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Tax-exempt revenue bonds series

Congressional threat?

Tax-exempt hospital bonds:

by George C. Phillips Jr.

THIS YEAR Congress will consider various proposals to restrict tax-exempt revenue bond financing. Some of the restrictions under consideration would substantially reduce the availability of tax-exempt financing to private, not-for-profit hospitals. Although efforts to restrict the issuance of tax-exempt bonds have been made in the past, the threat to tax-exempt hospitals has never been so direct.

While it may be appropriate to restrict the availability of tax-exempt financing to some users, there is no justification for any substantial reduction in healthcare facilities' access to the tax-exempt market. Indeed, none of the policy concerns advanced against tax-exempt hospital financing supports any change in current law as it applies to tax-exempt hospitals:

- Health policy considerations weigh strongly in favor of retaining the availability of tax-exempt hospital financing. Significant amounts of hospital capital are needed for facility renovation, replacement, conversion and expansion projects. Most of this capital must be raised by issuing debt because of the substantial impairment by the Federal government of tax-exempt hospitals' other sources of capital. As to the concern that tax-exempt hospital financing leads to excessive hospital expansion, this contention has never been demonstrated and all the evidence shows that this has not occurred.
- The budget policy concern of reducing Treasury revenue losses, presently a major impetus behind efforts to restrict tax-exempt financing, is less applicable to hospital bonds than to any other use of tax-exempt financing. This is primarily because of offsetting reductions in Medicare and Medicaid reimbursement payments for interest expense. For this and other reasons, tax-exempt hospital financing is far less expensive than generally estimated.
- The tax policy issues of whether a public purpose is served by the project financed, reductions in tax rate "progressivity," and the "uncontrollability" of tax expenditures have little force when applied to hospitals. Tax-exempt hospitals serve the unquestionably public purpose of maintaining the health of the community, the same essential public purpose served by public institutions. Any reduction in the progressivity of the tax rate structure is amply justified by this public purpose. In addition, effective governmental controls on hospital capital projects and on the issuance of bonds to finance these projects are already provided by state and local health planning agencies, rate-setting bodies, and bond issuing authorities. Indeed, because tax-exempt hospital financing is administered by a decentralized system of state and local governmental decisionmakers, this form of financial assistance is a particularly appropriate role for the Federal government in the Federal system.
- The credit policy concerns of capital allocation distortions and increased municipal bond interest rates also have little force in the case of hospitals. The extensive Federal involvement in healthcare financing has an overwhelming effect on the allocation of capital to hospitals, and the volume of tax-exempt hospital bonds is too small a fraction of the bond market to affect municipal bond rates significantly.

None of the policies supporting the restriction of tax-exempt financing would be advanced as much as the healthcare system would be damaged by any substantial decrease in the availability of this essential form of hospital financing.

Recent restrictions on substantially different tax-exempt bond users

Congress has restricted the availability of tax-exempt financing twice in the past two years.[8] In 1980, Congress acted to severely restrict the issuance of mortgage subsidy bonds for single family

key questions and answers

residences and to terminate their use on Dec. 31, 1983.[b] In 1981, Congress focused its attention on certain users of small-issue industrial development bonds (IDBs). Hearings were held on perceived abuses of IDB financing, such as the financing of recreational establishments and retail stores, and a report was issued recommending certain restrictions on their use.[c] However, there are substantial factual and policy differences that distinguish hospital bonds from these other types of tax-exempt financing considered by Congress. These other uses were not in furtherance of an essential public purpose such as maintaining the health of the community, were not performed by tax-exempt charitable institutions, and were not subject to any effective form of governmental control.

Proposals under consideration

The Reagan Administration, in its FY 1983 budget, has proposed restricting tax-exempt revenue bond financing. Some of the restrictions under consideration as this article is written would virtually terminate the availability of tax-exempt financing to private, not-for-profit hospitals. One such proposal would require that financially hard-pressed units of state or local government make additional financial contributions to tax-exempt hospital construction projects, beyond the substantial commitments already made to these institutions in the form of tax abatements. Such additional contribution requirements are not likely to be met in many cases. Another proposal would require that in addition to the approvals of health planning agencies, rate-setting bodies, and bond issuing authorities, an elected official or body also approve the project. This proposal and others would needlessly delay construction and increase project costs.

Questions and answers

The operation of tax-exempt hospital financing and the consequences of substantially restricting its use requires an examination of complex and interrelated questions of health, budget, tax and credit policy. These questions must be answered in the context of the present state of the nation's tax-exempt hospitals and the other elements of the healthcare system, including: the demand for hospital capital; the expected changes in other Federal policies affecting the availability and cost of capital for hospitals; and other unique circumstances of hospital financing.

The balance of this article is a discussion of these questions.

Health policy

Q. In this period of budgetary restraint, what special circumstances exist to justify this Federal benefit?

Continued on page 44

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[a] See generally, G. Gayer, *The Case For Hospital Tax-Exempt Bonds, Hospital Financial Management* June 1981, A. Fine and H. Pell, *Will Hospital Financing Survive Congressional Scrutiny, Hospital Financial Management*, June 1981, at 55.

[b] Omnibus Reconciliation Act of 1980, PL 96-499, Title IX. Also in 1980, the Carter Administration proposed to restrict the issuance of tax-exempt hospital bonds by requiring Federal health planning approval of each project seeking such financing; this proposal was withdrawn by the Reagan Administration and was not considered by Congress. 45 Fed. Reg. 41,096-99 (June 17, 1980).

[c] Oversight Committee's Report and Recommendations Relating to Small Issue Industrial Revenue Bonds, May 14, 1981. In a related action, Congress acted to prevent the IRS from expending any funds to enforce a revenue ruling (81-216) which effectively would prohibit state governments from issuing umbrella or pooled bond issues. However, this compromise amendment to the Continuing Resolution funding the Federal government until March 31, 1982, also provided that enforcement would be prohibited only in the case of IDBs backed by the state or local government, used by firms which had less than $25 million of capital expenditures in a three-year period, and where the proceeds were not used for various recreational purposes. The adoption of these limits was an ominous precedent for future Congressional action on IDBs and perhaps other revenue bonds as well.

Tax-exempt revenue bonds: Questions and answers

From page 43

A. Tax-exempt financing for private, tax-exempt hospitals is justified by the purposes for which this financing is used and by the impairment of these institutions' traditional sources of capital by actions of the Federal government.

Estimates of the amount of capital which will be needed by hospitals in the 1980's range from $130 to $190 billion—more than double the amount of hospital investment in the 1970's.[d] This capital is needed to renovate old, inefficient facilities, to replace obsolete equipment (especially in teaching and research hospitals), and to comply with various licensing requirements. It is also needed to convert existing facilities to new uses in response to changed modes of patient care. The introduction of more competition into the healthcare system is expected to increase the amount of capital required for many of these purposes. Where medically underserved areas exist, caused by population shifts and an aging population, capital is needed for expansion.

Tax-exempt financing for tax-exempt, private, not-for-profit hospitals is especially justified by the charitable nature of these institutions. Historically, these hospitals have improved the health of their communities by providing medical services to those in need, regardless of their ability to pay.

Tax-exempt hospital financing is also justified because the traditional sources of capital for private, tax-exempt hospitals—earnings accumulation, charitable contributions and debt issuance—have been impaired by a variety of Federal government actions:

- Earnings accumulation has been reduced, and in some cases entirely eliminated, by Federal and state reimbursement payments which do not fully cover the costs of service. Only about 85 percent of costs are reimbursed under Medicare and 70 percent under Medicaid.[e] These percentages will be reduced further by recently enacted reductions in Federal reimbursement payments,[f] and future additional reductions are expected. Earnings accumulation has also been reduced because of increasing amounts of charitable services and bad debts in a recessionary economy.
- Charitable contributions to tax-exempt hospitals are expected to decline as a result of the personal and corporate income tax rate reductions enacted by the 1981 Tax Act.[g]
- These reductions in earnings accumulation and charitable contributions will necessitate the increased use of debt to finance capital projects. The proportion of construction expenditures funded by debt issuance has been projected to increase from 78 percent in 1977 to more than 90 percent in 1983.[h] Credit-worthiness will decrease as debt-to-equity ratios increase and Federal reimbursement payments are reduced. These factors will make it increasingly difficult for hospitals to receive investment-grade bond ratings. Under such circumstances, entry into the 30-year long-term bond market becomes much more difficult, often necessitating the use of short-term borrowing. Such borrowing can result in a continual need to roll over increasing amounts of short-term debt, with the ultimate effect of eroding the financial structure of the institution to the point where long-term debt is completely unavailable.
- Current and foreseeable high interest rates make borrowing even at tax-free rates very costly. Much borrowing by hospitals in 1981 occurred despite high interest rates because of the inability of some institutions to delay construction further, because of the rapid escalation in construction costs coupled with the requirement that the project be completed within cost targets mandated by the health planning agency, and because of fears that Congress might restrict tax-exempt hospital borrowing.
  Borrowing at taxable rates would be extremely difficult for many nonprofit hospitals in today's market. The shorter maturity of taxable issues would result in insufficient cash flows because reimbursements for depreciation would be less than required payment of principal. Moreover, the additional cost of taxable issues would not be fully offset by increased interest expense reimbursements.
- Hospitals must compete for funds in credit markets. The borrowing needs of the Federal government, $41 billion in the first quarter of 1982 alone, as well as the large credit needs

Continued on page 46

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[d] J. Valiante, *The Dimensions of Capital Requirements*, presentation to the National Health Lawyers Association, Jan. 20, 1982; M. Hernandez, S. Valimahomed, *The Capital Formation Environment of the 1980s*, Hospital Corporate Planning, A Report of the 1980 National Forum on Hospital and Health Affairs.

[e] *Case for Bonds; see also*, P. Pine, M. Gornick, J. Lubitz, M. Newton, *Analysis of Services Received Under Medicare by Specialty of Physician*, Health Care Financing Review, September 1981. (In 1977, Medicare paid an average of 19.5 percent less than average submitted charges); L. Lewin, R. Derzon, R. Marguiles, *Investor-Owneds and Nonprofits Differ in Economic Performance. Hospitals*, July 1, 1981, (nonprofit hospitals price their services to Medicare and Medicaid patients at or below cost).

[f] Omnibus Budget Reconciliation Act of 1981, PL 97-35.

[g] See C. Clotfelter, L. Salamon, *The Federal Government and the Nonprofit Sector: The Impact of the 1981 Tax Act on Individual Charitable Giving* (a study for the Independent Sector) The Urban Institute, August 1981.

[h] *Evaluation of Future Hospital Capitalization*, a study commissioned by Standard & Poor's Corporation and prepared by Booz, Allen & Hamilton (hereinafter "Booz, Allen"), Oct. 16, 1978.

Tax-exempt revenue bonds: Questions and answers

From page 44

of utilities and municipalities, are likely to keep rates from falling substantially for some time.

- This competition for credit has been increased by the Federal government's recent increases in the supply of tax-exempt investments. The new "All Savers Certificates" and the expansion of the exemption for Individual Retirement Accounts are prime examples.
- The corporate and personal tax rate reductions of the 1981 Tax Act have increased tax-exempt interest rates by reducing the spread between taxable and tax-exempt rates from the 30 to 35 percent range to the 15 to 20 percent range.

Q. Would tax-exempt hospital financing continue to be justified if proposals to create a more competitive healthcare environment are implemented?

A. This form of hospital financing would not only continue to be justified, but would be necessary. Vigorous competition among healthcare providers will be hindered if tax-exempt hospitals, an essential part of the nation's healthcare system, suffer substantial, perhaps irreparable, erosion of their financial structure, capital base and physical plant. In addition, recent actions of the Federal government have already biased this competition against tax-exempt hospitals by enhancing the ability of investor-owned institutions to accumulate capital, while hindering the capital accumulation of tax-exempt institutions. For example:

- The Accelerated Cost Recovery System and the corporate tax rate reductions of the 1981 Tax Act assist investor-owned institutions in accumulating capital; tax-exempt hospitals received no such benefit.
- Because tax-exempt hospitals serve proportionately more patients whose care is financed

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Hospital bonding authority: The Illinois experience

The Illinois Health Facilities Authority was created by the Illinois General Assembly in 1972. It is one of 25 state authorities designed to assist not-for-profit hospitals, nursing homes, and other healthcare facilities provide quality medical care at the lowest cost via tax-exempt capital financing.

The authority is governed by a seven-member board serving seven-year terms appointed by the governor and confirmed by the state senate. The operating staff of the authority consists of five persons supported by external legal and financial advisors.

The purpose of the authority is realized through the sale of tax-exempt notes and bonds, the proceeds of which are loaned to qualified healthcare institutions to finance maintenance and expansion of their physical resources and in some instances to refinance existing indebtedness.

As of Jan. 1, 1982, the Illinois Health Facilities Authority had financed 123 issues representing $1,730,859,605 since its inception. The credit supporting these issues is that of the borrowing institution and does not constitute a debt of the state of Illinois other than the limited obligation of the authority. Until 1975, the authority retained title to the borrowing institution with a lease back to the institution until the bonds or notes were retired. Since that time, recognizing the restrictiveness of this methodology, the authority implemented "pass through" mortgages as security for the bonds and notes. This has become a standard for the industry.

The authority initiated specific equipment financing in the form of a $1,260,405 lease revenue note issued for Rush-Presbyterian-St. Luke's Medical Center in early 1977. In late 1977, this financing program was modified to a standardized "pass through" mortgage financing with the equipment as security and using standardized legal documents to minimize expenses of the transaction. Between November 1977 and October 1981, the authority issued $2,225,000 under this program. Then, in response to volatile market conditions and, in particular, the short-term market, as of November 1981, the authority implemented its "pooled equipment" financing program in the form of a $49,385,000 issue.

As the largest single issuer of healthcare bonds and notes in the nation, the authority continually strives to improve its services. In the past year, language was developed to permit "affiliate leases" for restructured corporations permitting diversification of the contemporary healthcare institution. Implementation of a "springing mortgage," which takes effect upon reaching a specified debt service coverage level, is another feature which gives the borrowing institution greater flexibility so long as its financial health remains intact.

Since the authority derives its revenues for operation from fees assessed the borrowing institutions, it strives to minimize the expenses of operation, while at the same time, being an innovative issuer. Over the course of the last two years, the authority has returned on a pro rata basis, fees of $250,000 to all of the healthcare institutions that have financed through the authority. Hopefully, this is reflected as a genuine effort to reduce the cost of health care.

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by Medicare and Medicaid than do investor-owned institutions,[i] they will suffer more severe revenue decreases as the result of reimbursement reductions. This disparity is expected to increase as investor-owned hospitals become reluctant to serve Medicare and Medicaid patients at reduced reimbursement levels, and these patients are shifted to tax-exempt hospitals.

- Tax-exempt borrowing helps to put the borrowing cost of tax-exempt hospitals on a basis comparable to the after-tax borrowing cost of investor-owned hospitals. Tax-exempt hospitals cannot take full advantage of tax incentives, such as the deduction of interest and depreciation expenses and investment tax credits, which benefit taxable institutions. Tax-exempt borrowing by tax-exempt institutions is an equalizer between tax-exempt and investor-owned institutions, not an advantage. The denial of tax-exempt financing to tax-exempt hospitals would amount to another action in favor of investor-owned institutions at the expense of tax-exempt institutions.
- Certain Medicare policies amount to additional disparate treatment directly affecting capital accumulation: Medicare reimburses investor-owned hospitals, but not tax-exempt hospitals, for return on equity, and does not reimburse tax-exempt hospitals for the costs of seeking charitable gifts.

Q. Are there effective controls on hospital construction and the issuance of tax-exempt hospital bonds?

A. Yes. There are effective governmental and marketplace controls on its use. Under Section 1122 of the Social Security Act, depreciation and interest expenses associated with a capital expenditure are not reimbursed unless the necessary planning approvals are obtained.[j] Because denial of such reimbursement in the case of any significant capital expenditure would seriously jeopardize repayment of the debt, a certificate of need or similar approval is a practical precondition to any tax-exempt financing.

In addition, bond issuing authorities can effectively deny tax-exempt financing to projects that are not economically sound or not in the interest of the people of the state. Most important, because the hospital is ultimately responsible for repayment of the debt issued, investors demand that the proposed project is necessary; otherwise the revenue necessary for debt repayment will not be forthcoming.

Q. Has tax-exempt financing led to the construction of unneeded hospital capacity?

A. A causal relationship between the issuance of tax-exempt hospital bonds and the amount of hospital construction has never been demonstrated. Rather, the facts show that tax-exempt financing has been used primarily to refinance existing debt, usually at lower costs, and to renovate existing facilities or convert them to new uses, such as ambulatory care centers which reduce the number of beds and reduce healthcare costs.

- Since the early 1970's, when tax-exempt financing became generally available to hospitals, and tax-exempt hospital bonds were issued in significant amounts, the number of acute care beds per thousand population has not increased substantially (from more than 4.2 in 1972 to less than 4.5 in 1979). In addition, the rate of growth in this statistic has not increased at all since at least 1960.[k]
- Since 1972, there has been a strong negative correlation between the issuance of tax-exempt hospital bonds and the amount of hospital construction, including renovation, replacement and facility conversion. From 1972 to 1979, the volume of tax-exempt hospital bond issues has increased 670 percent, and the volume used for construction has increased 660 percent[l] while hospital construction starts declined by 40 percent[m] and hospital construction completed declined by 38 percent[n] (all figures are in constant dollars).
- Of 113 institutions completing tax-exempt financing through 15 state health facilities financing authorities (of 20 authorities active nationwide) in 1978 and 1979, 24 increased bed capacity, while seven reduced capacity and 82 left capacity unchanged.[o]
- From 1974 to 1979, between 25 and 46 percent of the volume of tax-exempt hospital bonds issued were for refinancing at lower interest rates.[p] Such refinancing lowers the costs of health care by reducing interest expenses.

Q. Is tax-exempt financing an efficient way of assisting hospital investments?

A. Yes. The efficiency (the ratio of hospital savings to Treasury revenue losses) of tax-exempt hospital financing has been substantially understated by the Treasury and the Congressional Budget Office (CBO). It is likely to be higher than the efficiency of the alternative,

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[i] L. Lewin, R. Derzon, R. Marguiles, *Investor-Owneds and Nonprofits Differ in Economic Performance. Hospitals,* July 1, 1981.

[j] See 42 U.S.C. §1320 a-1.

[k] Booz, Allen, p. 4.

[l] Congressional Budget Office, *Tax Subsidies for Medical Care: Current Policies and Possible Alternatives* (hereinafter "Tax Subsidies"), January 1980.

[m] American Hospital Association, *Report on Tax-Exempt Hospital Financing* (hereinafter "AHA Report").

[n] Bureau of the Census.

[o] *AHA Report* p. 9.

[p] See *Tax Subsidies*, p. 49.

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direct Federal subsidy programs, for the following reasons:

- Actual Treasury revenue losses are much less than generally estimated, and may even be less than hospital savings.
- Administrative costs in the issuance of tax-exempt financing are less than comparable administrative costs in Federal direct subsidy programs.[q]
- Another important but often overlooked aspect of efficiency is the ratio of the value of the construction project to its cost. Because tax-exempt financing can be arranged much more quickly than a direct subsidy could be approved, construction cost increases caused by delays (generally estimated to be one percent per month), which add nothing to the value of the project, are minimized.
- The principal source of inefficiency identified by the Treasury and the CBO (returns to high-bracket investors in excess of the after-tax returns on their taxable investments) will be substantially decreased by the recent reduction in the top marginal tax rate from 70 to 50 percent.[r]

Q. Is this benefit targeted to those projects where capital is most needed?

A. The benefits of tax-exempt financing are directed to needed projects by a decentralized system of state and local government control, rather than by the Federal government. State health planning agencies, state rate-setting bodies, state bond issuing authorities, and investors effectively direct these benefits to needed projects.

Budget policy

Q. Would the termination of tax-exempt hospital financing result in a significant increase in Treasury revenues?

A. No. The actual revenue loss caused by the issuance of tax-exempt hospital bonds is much less than the $100 million (in FY 1982) estimated by the CBO, for the following reasons:

1. The CBO estimates do not account for offsetting reductions in Federal, state and local assistance and insurance program reimbursement payments.

- Tax-exempt hospital financing reduces Federal, state and local healthcare reimbursement payments because savings to beneficiary hospitals are passed back to third-party cost payors in the form of lower reimbursements for interest expenses. The Federal government receives direct benefits through reduced Medicare and Medicaid reimbursement payments, and will benefit even more if Medicaid is federalized as the President has proposed. State and local governments similarly benefit through reduced reimbursement payments in Medicaid and other assistance programs and by reduced premium payments to private insurers, for whom state governments are sometimes the largest customer.
- The reduction in Federal Medicare and Medicaid reimbursement payments in 1980 offset at least 27 percent of the CBO-estimated Treasury losses.[s]
- Another 6 percent of the CBO-estimated revenue losses were offset by reduced state and local government reimbursement payments un-

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[q] Administrative costs of the Hill-Burton program do not provide a fair comparison because they do not include many costs of financing—costs such as those for document preparation, placement fees, and legal fees—and also because the level of monitoring of that program has been criticized as insufficient by the General Accounting Office. See GAO report, *Hospital Loan Assistance Programs: Actions Needed to Reduce Anticipated Defaults*, HRD-79-64, June 27, 1979.

[r] This source of inefficiency is the return received by high-bracket investors above that necessary to attract them from taxable investments. The interest rate spread between taxable and tax-exempt bonds, historically 30-35 percent, reflects the benefit to the borrower and the break-even marginal tax rate at which investors are indifferent between holding taxable and tax-exempt bonds. Investors of tax-exempt bonds in brackets above this marginal rate get a higher return than investors in the marginal tax bracket require to clear the market. Although factors other than the top marginal tax rate undoubtedly influence the tax rate to tax-exempt rate spread, that spread has now narrowed to 15 to 20 percent, indicating a major reduction in this source of inefficiency.

[s] Offsetting reimbursement savings are the product of interest savings to hospitals and the percent of hospital revenues which are paid by the Federal government. In 1978, the Senate Budget Committee estimated that the interest expense savings of institutions benefitting from tax-exempt financing equalled 75 percent of Treasury revenue losses. On the average, the Federal government paid 37 percent of the revenues of hospitals benefitting from tax-exempt financing in 1980, primarily through Medicare and Medicaid payments. Because these payments include reimbursement for interest expense on a *pro rata* basis, 37 percent of the savings, which were assumed to equal 75 percent of revenue loss, was passed back to the Federal government in the form of reduced payments. See generally; R. Gibson and D. Waldo, *National Health Expenditures, 1980*, Health Care Financing Review September 1981 (hereinafter "National Health Expenditures") (Of the total expenditures for hospital care, the Federal government paid 41 percent and state and local governments paid 13 percent in 1980. Total hospital expenditures equalled $99.6 billion. Subtracting expenditures at institutions which cannot benefit from the use of tax-exempt financing (Veterans Administration, $4.8 billion, DOD, $3.3 billion, Public Health Services, $1.1 billion, and state and local hospitals, $6 billion) leaves $84.4 billion; Federal Medicare ($26.3 billion) and Medicaid ($5.2 billion) are 37 percent of this $84.4 billion.)

[t] State and local governments paid 8 percent of hospital revenues through Medicaid and other assistance and insurance program payments. This 8 percent share of the 75 percent savings equals 6 percent of the revenue loss. See Id. (Of the $84.4 billion spent on hospitals which can benefit from tax-exempt financing, $6.8 billion (8 percent) was spent by state and local governments: state Medicaid payments ($4.3 billion), state and local workmen's compensation ($1.9 billion) and public assistance ($.6 billion). This does not include $6 billion spent on state and local hospitals.)

der Medicaid and other assistance and insurance programs in 1980.[t]

2. The CBO estimates do not account for increased tax revenues resulting from investment-stimulated economic activity.

- All Federal tax and direct expenditures are assumed to increase economic activity and thereby increase tax revenues in the amount of approximately 30 percent of the amount of the expenditures. Expenditures which directly induce productive capital investments, however, have a greater than average economic stimulus.[u] This is especially true where nonproductive speculative investments, which are most often used by high-bracket taxpayers who invest in tax-exempt securities, are displaced by productive investment activities.

3. The CBO estimates overstate the amount of revenue losses caused by displaced taxable issues.

- Many issues of tax-exempt debt would not be replaced by taxable debt issues. Most refinancing (which accounted for between 25 and 46 percent of all tax-exempt hospital bonds from 1974 to 1979)[v] would not be undertaken at taxable rates.
- In addition, many investors in taxable hospital securities, such as pension funds, pay little or no Federal income tax. The replacement of such debt by tax-exempt bonds therefore causes little loss in tax revenues.

4. The CBO estimates do not account for the

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u. In hearings on small issue IDBs, a University of Chicago economist, Dr. Roger C. Kormendi, disagreed with CBO and Treasury IDB revenue loss estimates and their underlying assumptions. Hearings in the House Committee on Ways and Means, Subcommittee on Oversight, April 8-10, 1981. In the study on which his testimony was based, he and co-author Thomas T. Nagle (also an economics professor at the University of Chicago's Graduate School of Business) had concluded that revenue losses due to IDB sales were only one-sixth the amount estimated by CBO. See also R. Kormendi and T. Nagle, *A Summary of the Nature and Effect of Small-Issue Industrial Development Bonds* (1981); R. Kormendi and T. Nagle, *The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds*, July 26, 1979. Other witnesses cited a 1980 study by the economic consulting firm of Norman B. Ture, who is now Treasury Undersecretary for Tax and Economic Affairs, concluding that the economic activity generated by IRBs causes net gains in Federal tax revenues. Norman B. Ture, *Economic and Federal Revenue Effects of Changes in the Small Issue Industrial Development Bond Provisions*.

v. See *Tax Subsidies* p. 49.

All of these Bonds having been sold, this announcement appears as a matter of record only.

In the opinion of Bond Counsel, under existing laws and regulations, interest on the Series 1982 Bonds is exempt from federal income taxation by the United States of America and, under existing laws of the State of Hawaii, from all state, county and municipal taxes except inheritance, transfer and gift taxes.

New Issue / February, 1982

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Department of Budget and Finance
of the State of Hawaii

Special Purpose Mortgage Revenue Bonds
(Wahiawa General Hospital Project), Series 1982

Dated: March 1, 1982

$360,000 Serial Bonds Due July 1, 1985-1992
$9,540,000 Term Bonds Due July 1, 2012
Price of all Bonds: 100%
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tax rate reductions of the Economic Recovery Tax Act of 1981 (the 1981 Tax Act).

- The across-the-board 23 percent rate reductions, and more important, the reduction of the top rate from 70 to 50 percent, will tend to reduce the number of tax-exempt bonds issued by increasing the tax-exempt interest rate. The tax rate reductions will also result in less tax loss per tax-exempt bond issued because any displaced taxable investments would have been taxed at a lower rate.
- The reduction in the top tax rate from 70 to 50 percent will increase the percentages of offsetting interest expense reimbursement savings above the 27 percent Federal and 6 percent state and local offsets which existed in 1980. By decreasing the difference between the tax brackets of the "marginal" bond buyer and buyers in the highest bracket, hospital savings as a percentage of revenue losses, and hence offsetting savings as a percent of revenue loss, will increase.

Tax policy

Q. Does the use of tax-exempt financing reduce the equity and progressivity of the tax system?

A. All tax preferences reduce progressivity. However, this reduction will be lessened by the lowering of the top tax bracket from 70 percent to 50 percent. In addition, any such decrease in tax progressivity is amply justified by the charitable nature of the institutions receiving the benefit of this tax-exemption and by the public purposes served by the investments assisted.

Q. Are tax-exempt hospital bond revenue losses uncontrollable because they do not require Congressional approval each year?

A. It is true that these revenue losses are not subject to the appropriations process, as is the case for all tax expenditures. However, as discussed earlier, there are other effective governmental and marketplace controls on the issuance of hospital bonds.

Credit policy

Q. Does this form of Federal assistance for hospital financing distort the free market's allocation of capital?

A. The extensive Federal involvement in health-care financing, and thus indirectly in both the supply of and demand for health facilities capital, makes comparisons to capital allocation in a theoretical free market extremely difficult. Tax-exempt hospital financing, however, is less intrusive on the operation of a free market than other forms of Federal involvement in health care.

Q. Does the amount of hospital tax-exempt bonds significantly increase the interest rates, and thus the borrowing costs, for other state and local governmental purposes?

> *By far the most significant effect on state and local governments of the use of tax-exempt hospital bonds is to decrease their expenditures for health care.*

A. There is no evidence that the volume of tax-exempt hospital bonds issued in any area is having a significant effect on municipal bond interest rates. Inflation and Federal fiscal and monetary policies are by far the dominant influences on municipal bond rates. In addition, it is no more appropriate to attribute any increase in municipal bond rates to hospital bonds than to attribute such increases to bonds issued for other purposes because the interests served by hospital bonds are no less public than those served by other municipal bond issues. By far the most significant effect on state and local governments of the use of tax-exempt hospital bonds is to decrease their expenditures for health care. This is especially so in states with urban hospitals.

Q. Has the volume of hospital tax-exempt bond issues increased the cost of borrowing to the Federal government?

A. A comparison of the relative amounts of hospital tax-exempt bonds issued to the level of Treasury and corporate bond issues indicates that the effect of hospital bond issues on Treasury interest rates must be quite small. In 1981, $93 billion of U.S. Treasury were issued, $34 billion of publicly offered corporate bonds (with private issues bringing the corporate total to $47 billion), $45 billion of long-term tax-exempt bonds (with shorter-term tax-exempt financing bringing the tax-exempt total to $80 billion), and $5 billion of tax-exempt hospital bonds.[w] Therefore, tax-exempt hospital bonds accounted for 11 percent of long-term tax-exempt bonds issued and 6 percent of all tax-exempt issues, and equalled 5 percent of the volume of Treasury bonds issued and 3 percent of the total public bond market.

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[w] See, e.g., *The Bond Buyer*, Jan. 4, 1982, p. 18.

[x] M. Lightle, *Changes in Sources of Capital for Health Care Providers*, presented at National Health Lawyers Association, Jan. 20, 1982.

Conclusion

The problem of attracting affordable capital is expected to be the critical issue facing hospitals in the 1980's. Approximately $150 billion will be needed by hospitals in the 1980's for renovation, replacement of obsolete equipment, conversion of facilities to adapt to a new, more competitive environment, and expansion in response to significant demographic changes.

In 1979, tax-exempt financing was the source of 55 percent of all hospital construction capital.[2] Because of reductions in earnings accumulation and income from philanthropy, caused in major part by Federal government reimbursement and tax policies, debt financing will become even more important in the future. Restricting the access of tax-exempt hospitals to the tax-exempt market would make it extremely difficult for many hospitals to finance these projects. This inability to undertake needed capital improvement projects would reduce the quality of patient care in a hospital's service areas and shift the burden of health care to other area institutions, especially already hard pressed public hospitals.

Those hospitals able to finance at taxable rates would suffer cash flow problems and incur higher interest expenses, thus increasing the reimbursement expenses of Federal, state and local governments under Medicare, Medicaid, and other assistance and insurance programs.

The ability of the tax-exempt sector of the healthcare industry to raise needed capital has been severely and disproportionately impaired by actions of the Federal government and by the state of the bond market. Further impediments would not materially advance the budget, health, tax or credit policy goals advanced as justification for restriction on tax-exempt hospital financing and would substantially impair the ability of the private, not-for-profit sector of the healthcare system and the system as a whole to maintain the hard-earned level of health care. ☐

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